S. Hrg. 98-947

REPEAL OF FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 1915

JUNE 19, 1984

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REPEAL OF FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

TUESDAY, JUNE 19, 1984

U.S. SENATE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:07 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Malcolm Wallop (chairman) presiding.

Present: Senators Wallop and Bentsen.

[The committee press release, the bill S. 1915, the description of the bill by the Joint Committee on Taxation, and the prepared statement of Senator Wallop follow:]

[Press Release No. 84-140]

FINANCE COMMITTEE SCHEDULES HEARING ON S. 1915, THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA) REPEAL BILL

Senator Robert J. Dole (R., Kans.), Chairman of the Senate Committee on Finance, announced today that the Committee will hold a public hearing on S. 1915, a bill introduced by Senator Goldwater to repeal the Foreign Investment in Real Property Tax Act (FIRPTA).

In 1980, the Congress adopted the Foreign Investment in Real Property Tax Act, requiring that foreign persons who dispose of U.S. real property interests pay tax on any gain realized on the disposition. The interests on whose disposition recognition occurs include real estate and shares in certain corporations owning primarily real estate. The intent of the legislation was to treat foreign investors the same as U.S. persons by removing certain preferential tax treatment previously accorded them.

The Act provides for enforcement of the tax on foreigners through a system of information reporting designed to identify foreign owners (rather than sellers) of U.S. real property interests.

The hearing will be held on Tuesday, June 19, 1984 at 10:00 a.m. in SD-215 of the Dirksen Senate Office Building.

II

98TH CONGRESS
1ST SESSION

S. 1915

To amend the Internal Revenue Code of 1954 to repeal capital gains tax on disposition of investments in United States real property by foreign citizens.

IN THE SENATE OF THE UNITED STATES

OCTOBER 3, 1983

Mr. GOLDWATER introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to repeal capital gains tax on disposition of investments in United States real property by foreign citizens.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REPEAL OF CAPITAL GAINS TAX ON DISPOSITION OF INVESTMENTS IN UNITED STATES REAL PROPERTY BY FOREIGN CITIZENS.

(a) IN GENERAL.—Section 897 of the Internal Revenue Code of 1954 (relating to disposition of investment in United States real property) is repealed.

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (5) of section 861(a) of such Code (relating to gross income from sources within the United States) is amended to read as follows:

"(5) SALE OR EXCHANGE OF REAL PROPERTY.—Gains, profits, and income from the sale or exchange of real property located in the United States.".

(2) Subsection (a) of section 862 of such Code (relating to gross income from sources without the United States) is amended—

(A) by inserting "and" after the semicolon at the end of paragraph (6),

(B) by striking out "; and" at the end of paragraph (7) and inserting in lieu thereof a period, and

(C) by striking out paragraph (8).

(3) Subsection (g) of section 871 of such Code (relating to tax on nonresident alien individuals) is amended by striking out paragraph (8).

(4) Subsection (a) of section 882 of such Code (relating to tax on income of foreign corporations connected with United States business) is amended by striking out paragraph (3).

(5) Subsections (c) and (d) of section 1125 of the Foreign Investment in Real Property Tax Act of 1980 are repealed.

(c) CLERICAL AMENDMENT.—The table of sections for subpart C of part II of subchapter N of chapter 1 of such Code is amended by striking the item relating to section 897.

SEC. 2. REPEAL OF SPECIAL REPORTING REQUIREMENTS WITH RESPECT TO UNITED STATES REAL PROPERTY INTERESTS.

(a) IN GENERAL.—Section 6039C of the Internal Revenue Code of 1954 (relating to returns with respect to United States real property interests) is repealed.

(b) CONFORMING AMENDMENT.—Section 6652 of such Code (relating to failure to file certain information returns, registration statements, etc.) is amended—

(1) by striking out subsection (g), and

(2) by redesignating subsections (h) and (i) as subsections (g) and (h), respectively.

(c) CLERICAL AMENDMENT.—The table of sections for subpart A of part III of chapter 61 of such Code is amended by striking out the item relating to section 6039C.

SEC. 3. EFFECTIVE DATE.

(a) REPEAL OF TAX.—The amendments made by section 1 shall apply to dispositions in taxable years beginning after December 31, 1983.

(b) REPEAL OF REPORTING REQUIREMENTS.—The amendments made by section 2 shall apply to returns for calendar years beginning after December 31, 1983.

○

DESCRIPTION OF S. 1915

RELATING TO

TAX TREATMENT OF FOREIGN INVESTMENT IN U.S. REAL PROPERTY

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON JUNE 19, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on S. 1915 (introduced by Senator Goldwater) on June 19, 1984. S. 1915 would repeal the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) which generally taxes gains of foreign investors on the disposition of U.S. real properly interests.

This pamphlet, prepared in connection with the hearing, has four parts. The first part is a summary. The second part provides background information on U.S. taxation of foreign investors and describes the provisions of FIRPTA. Part three describes the provisions of S. 1915. Finally, part four discusses certain issues raised by the bill.

I. SUMMARY

Present Law

Foreign investors who are not engaged in the conduct of a U.S. trade or business and who, therefore, are not normally taxed on a net basis may elect to be taxed on the income from U.S. real property investment on a net basis (Code secs. 871(d) and 882(d)). Often, as a result of the election, a foreign investor will pay no tax on the income because deductible expenses exceed income.

Before the enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), capital gains of foreign investors on the disposition of U.S. real property interests were not subject to U.S. income tax unless the gains were effectively connected with a U.S. trade or business or the foreign investor was an individual present in the United States 183 days or more during the year. Foreign investors could use a number of planning techniques to avoid U.S. tax on U.S. real property gains, even when the net basis taxation election had previously been made.

In general, FIRPTA subjects to U.S. tax all gains of nonresident aliens and foreign corporations on the disposition of U.S. real property interests. This is accomplished by treating all gains and losses of foreign investors on the disposition of U.S. real property interests as if they are effectively connected with a U.S. trade or business of the foreign investor. Net gains on such dispositions are generally taxable to foreign investors at the same graduated capital gains rates that apply to gains of U.S. persons on the disposition of real property interests. In the case of individual foreign investors, tax is imposed at a minimum rate of 20 percent of net property gains (or 20 percent of alternative minimum taxable income, if less).

"U.S. real property interests" include certain interests in U.S. real property holding corporations (U.S. RPHCs). Gains on the disposition of foreign corporate stock, however, are not subject to tax under FIRPTA. Instead, FIRPTA, with certain exceptions, taxes foreign corporations on the distribution of appreciated U.S. real property interests to their shareholders (and on the sale of such interests in connection with their liquidation). However, if a foreign corporation holds a U.S. real property interest and, under any U.S. treaty obligation, is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect in accordance with certain rules to be treated as a U.S. corporation for FIRPTA purposes.

FIRPTA also taxes certain dispositions of interests in partnerships, trusts, and estates, certain distributions of real estate investment trusts (REITs) and certain contributions to capital.

FIRPTA authorizes the Secretary of the Treasury to prescribe regulations providing the extent to which nonrecognition rules of the Code will (or will not) apply to override its provisions. Beginning in 1985, FIRPTA generally will prevail over any conflicting U.S. treaty provisions remaining in effect.

FIRPTA contains reporting requirements to identify when taxable transactions have occurred, but the deadlines for compliance with these requirements have been postponed by the Internal Revenue Service, pending the issuance of final regulations. To simplify the administration of FIRPTA and to insure collection of the tax imposed, the Senate has voted several times to impose withholding on dispositions of U.S. real property interests by foreign investors. As of the date of printing of this pamphlet, the House and Senate conferees on H.R. 4170 had agreed to a modified withholding proposal.

S. 1915

S. 1915 would repeal FIRPTA. Under the bill, gains of foreign investors on the disposition of U.S. real property interests would not be subject to U.S. income tax unless, as before FIRPTA, the gain is effectively connected with a U.S. business or is realized by a nonresident alien individual who was present in the United States 183 or more days during the year. The repeal of FIRPTA would be effective for dispositions made in taxable years beginning after 1983 and for returns for calendar years beginning after 1983.

II. BACKGROUND AND PRESENT LAW

Taxation of Foreign Persons Generally

Under the Code, U.S. persons are taxed on their worldwide income. Nonresident aliens and foreign corporations engaged in a U.S. trade or business are generally taxed on the U.S. source income of that business in the same manner, and at the same rates, as U.S. persons. However, their foreign source income not connected with that business is not taken into account in determining the applicable rates of U.S. tax.

In contrast, the U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with a U.S. business is generally subject to a different tax regime. The Code provides that a foreign individual or corporation is ordinarily subject to a 30-percent tax on the *gross* amount of certain passive income such as dividends and interest, which is received from U.S. sources and is not effectively connected with a U.S. business. This tax, which is collected by means of withholding, generally satisfies the taxpayer's U.S. income tax liability on the income. This tax is often reduced by income tax treaty.

Prior to the enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), capital gains not effectively connected with a U.S. business were not subject to any U.S. income tax, except in the limited situation of nonresident individuals who were present in the United States 183 days or more during the year.

Non-FIRPTA Taxation of Foreign Investment in U.S. Real Property

Whether a foreign investor in U.S. real property is engaged in a U.S. trade or business and, thus, is taxable on income from his investment on the same basis as a U.S. person, depends on all the facts and circumstances. For example, a foreign investor who enters into a single long-term net lease (under which the lessee is responsible for operation of the property and pays the expenses) probably would not be engaged in a U.S. trade or business, whereas a taxpayer who owns and manages a commercial building would be so engaged.

If a foreign taxpayer is not actually engaged in a U.S. trade or business, he is permitted under the Code to elect to be treated as if he were so engaged with respect to all his real property held for the production of income (Code secs. 871(d) and 882(d)). This election is provided because rental income, unlike other types of passive income, ordinarily has associated with it significant expenses. Therefore, a tax equal to 30 percent of the gross rentals could exceed the entire economic income from the property. If the election is made, the foreign taxpayer may reduce his gross income from the real property by deductible expenses, such as depreciation, mortgage interest, and real property taxes. The taxpayer is then taxed on the net income at the graduated rates that generally apply to U.S. taxpayers. Often, as a result of the election, the foreign investor will pay no tax on the current income because expenses exceed gross income. (This result would be the same if a U.S. person owned the property.) By making the election, however, the taxpayer also—in theory—subjects himself to U.S. tax on any capital gains from the sale or exchange of the property. The election, once made, is binding on the taxpayer in all subsequent years unless consent to revoke it is obtained from the Internal Revenue Service.

FIRPTA effectively eliminated a number of planning techniques whereby a foreign investor could avoid tax on the capital gain that resulted on the sale of a U.S. real property interest, even after having obtained the advantage of being taxed on current income from the real property interest on a net basis.

First, a foreign investor who is actually engaged in a U.S. real estate business and is, therefore, taxed on current income from the property on a net basis may sell the property on the installment basis and receive most or all of the payments in years following the year of the sale. Prior to FIRPTA, if the investor were not actually engaged in a U.S. trade or business in later years when the installment payments were received (and had not made the election to be treated as if he were), the gain would not have been treated as effectively connected with a trade or business in the later years and would therefore have gone untaxed.

Second, prior to FIRPTA, a foreign investor could generally exchange his U.S. real property held for productive use or investment for other property of a like kind, whether within or outside the United States, without recognition of gain. If the property acquired in the exchange were outside the United States, the gain recognized on the ultimate sale of the property received in the exchange also would not be subject to U.S. tax.

Third, a taxpayer could obtain the benefits of current taxation on a net basis and exemption from tax on the gain on ultimate sale by investing in U.S. real property indirectly through a foreign holding company which either was actually engaged in U.S. business or made the election. Such a holding company is subject to tax on the income it receives from the property, but, as noted earlier, there may often be no taxable income on a current basis. Also, the corporation may be able to reduce or eliminate its taxable income by paying deductible interest to its investors. Ordinarily, dividends and interest paid by a foreign corporation deriving most of its income from U.S. sources are subject to U.S. withholding taxes. However, these taxes are sometimes waived on a reciprocal basis under tax treaties between the United States and other countries.

Before FIRPTA, the investors in such a foreign holding company could avoid U.S. tax on the gain from the sale of the property by either of two methods. First, if the corporation sold the property and followed a plan of liquidation meeting certain requirements, the corporation was not taxable on the gain under a general rule of the Code that exempts liquidating corporations from tax on gains from the sale of property (sec. 337). Moreover, the shareholders and security holders generally were not taxable when they exchanged their stock and securities in liquidation for the proceeds of the sale of the real property because, as foreign investors, they generally were not subject to U.S. capital gains tax. While the corporation was engaged in a U.S. business, its business was not imputed to its investors under the Code. Mere ownership or sale of stock is generally not a trade or business. Ordinarily, therefore, the gains were not effectively connected with a U.S. business and thus escaped U.S. tax.

Alternatively, if the foreign holding company investors instead sold their stock or securities, they generally were not subject to tax on the gain for the same reasons that they generally did not recognize gain in a liquidation. Assuming that the sales price reflected the appreciated value of the real property, the purchasers of the stock, even if U.S. persons, could then liquidate the corporation without realizing gain subject to U.S. tax because their basis in the stock for purposes of determining gain on the liquidation was their purchase price for the stock.

Fourth, some U.S. tax treaties (such as the existing income tax treaty with the Netherlands Antilles) provide a more liberal net basis taxation election for real property income than the Code—these treaties permit an election to be made on a year-by-year basis without restriction. A foreign investor entitled to the benefits of such a treaty and not actually engaged in a U.S. business can use the treaty election to be taxed on a net basis in years prior to the year of sale. In the year of sale, the investor is free under these treaties not to make the treaty election. Prior to FIRPTA, by not making the election in that year, the investor avoided tax on the gain on the sale of the property because of his lack of a U.S. business.

Fifth, a number of existing U.S. tax treaties contain reciprocal provisions that prohibit the United States from taxing certain types of U.S. source capital gains of foreign investors who are entitled to treaty benefits. While these provisions reciprocally exempting capital gains generally do not apply with respect to real estate (that is, they do not restrict either country from taxing gains on sales of its real estate derived by residents of the other), they generally apply with respect to stock in real estate holding corporations. Prior to FIRPTA, these treaty provisions prevented U.S. tax tax on disposition of some U.S. real property interests.

FIRPTA

In general

Congress passed FIRPTA (Code secs. 897, 6039C, and 6652(g)) in November 1980 as part of the Omnibus Reconciliation Act of 1980. FIRPTA generally taxes nonresident aliens and foreign corporations on gains on the disposition of U.S. real property interests. Tax is imposed regardless of whether the gain is effectively connected with a U.S. trade or business or the seller was present in the United States. FIRPTA contains reporting requirements to identify when taxable transactions have occurred.

Congress made a number of technical amendments to FIRPTA in the Economic Recovery Tax Act of 1981. The discussion below incorporates these (and subsequent) technical amendments.

Amount of tax

Gains and losses of foreign investors on the disposition of U.S. real property interests generally are treated under FIRPTA as if they are effectively connected with a U.S. trade or business of the foreign investor. Thus, net gains are generally taxable to foreign investors at the same U.S. graduated capital gains rates that apply to gains of U.S. persons. However, in the case of individual foreign investors, tax is imposed at a minimum rate of 20 percent of net property gains (or 20 percent of alternative minimum taxable income, if less).

Effectively connected losses reduce the gain subject to tax. Losses attributable to the U.S. real property from years prior to the year of sale are generally allowed as deductions against the foreign investor's effectively connected U.S. gross income (including gains from real property sales) when the foreign investor makes the Code election to be taxable on a net basis on its U.S. real property income.

Definition of U.S. real property interest

FIRPTA taxes gains on the disposition of interests in real property (including interests in mines, wells, or other natural deposits) located in the United States or the Virgin Islands. The term "interest in real property" includes fee ownership and co-ownership of land or improvements, easements, and options, to acquire leaseholds of land or improvements thereon. Moreover, the term includes partial interests such as life estates, remainders, reversions, and rights of refusal in real property. Proposed Treasury regulations provide that the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property (Prop. Treas. Reg. sec. 1.897(c)).

Movable walls, furnishings, and other similar personal property associated with the use of real property are considered real property for purposes of FIRPTA.

U.S. real property interests also include certain holdings in U.S. real property holding corporations, discussed below.

U.S. real property holding corporations (U.S. RPHCs)

A. U.S. RPHC is any corporation the fair market value of whose U.S. real property interests is at least 50 percent of the sum of the values of its (1) U.S. real property interests, (2) interests in foreign real property, and (3) other assets used or held for use in the trade or business during the taxable year. Any interest in a corporation (whether foreign or domestic), other than an interest solely as a creditor, is treated as a U.S. real property interest unless the taxpayer establishes that the corporation was at no time a U.S. RPHC during the period after June 18, 1980 (the general effective date of FIRPTA) during which the taxpayer held the interest, or the five years preceding the disposition of the interest, whichever is shorter ("five-year base period").

In determining whether a corporation is a U.S. RPHC, a corporation that is a partner in a partnership takes into account its proportionate share of all assets of the partnership. Thus, for example, the corporate partner counts its proportionate share of the foreign real estate of the partnership. The same rules apply to trusts and estates in which a corporation has an interest and to a chain of successive partnerships, trusts or estates in which a corporation has an interest. Look-through rules also apply to a controlling interest held by a corporation in another corporation, with respect to assets held downward through the chain of ownership. For these purposes, a controlling interest is 50 percent or more of the fair market value of all classes of stock of the second corporation.

In general, gains from the disposition of an interest in a U.S. RPHC are subject to tax. However, no tax is imposed on the sale of publicly traded corporate stock by an investor who, throughout the five-year base period, owned five percent or less of the class of stock sold. FIRPTA also does not tax gains on the disposition of stock in a foreign corporation.

Foreign corporations

As indicated above, FIRPTA generally taxes foreign corporations on gains on the disposition of U.S. real property interests, but does not tax shareholders of foreign corporations on gains on the disposition of their stock.

Under a special rule, FIRPTA generally taxes foreign corporations on the distribution (whether or not in liquidation) to their shareholders of appreciated U.S. real property interests and on the sale of such interests in connection with their liquidation. Tax generally is imposed in these cases notwithstanding any nonrecognition provision of the Code.

Gain is not recognized by a foreign corporation on a distribution of appreciated U.S. real property, however, if the distributee takes a carryover basis in the property and, at the time of receipt of the property, the distributee would be subject to tax on a subsequent disposition of the property. Gain is also not recognized by a foreign corporation on a distribution of appreciated U.S. real property if nonrecognition is provided under regulations (authorized by FIRPTA) regarding the application of Code nonrecognition rules to transactions otherwise subject to FIRPTA (discussed below).

If a foreign corporation holds a U.S. real property interest and, under any treaty obligation of the United States, is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect to be treated as a U.S. corporation for purposes of FIRPTA. The election may be revoked only with the consent of the Secretary. The election may be made only if all shareholders of the corporation at the time of the election consent to the election and specifically agree that any gain from the disposition of the interest after June 18, 1980, which would be taken into account under the legislation, will be taxable even if such taxation would not be allowed under a treaty to which the United States is a party. If a class of stock in a foreign corporation is traded on an established securities market, then the consent need only be made by a person who held more than five percent of that class of stock. The Internal Revenue Service has proposed additional rules governing the making of the election (See Prop. Treas. Reg. secs. 1.897-3 and 1.897-4).

The election to be treated as a domestic corporation is the exclusive remedy for any person claiming discriminatory treatment because of FIRPTA.

As amended by the Economic Recovery Tax Act of 1981, FIRPTA provides U.S. shareholders of a foreign corporation holding U.S. real property interests that adopts a plan of complete liquidation with a credit against any tax imposed on them on the surrender of their stock. The credit is available to U.S. shareholders who acquired their stock before the general effective date of FIRPTA and have held it continuously since. The credit equals the U.S. shareholder's proportionate share of the tax imposed on the liquidating foreign corporation on the distribution or liquidation-related sale of its U.S. real property interests. This credit effectively prevents the imposition of FIRPTA tax at both the corporate and shareholder levels in connection with the complete liquidation of a foreign corporation holding appreciated U.S. real property interests. The credit insures that a complete liquidation of a foreign corporation, like a complete liquidation of U.S. corporation, will be taxed at one level only under FIRPTA.

Partnerships, trusts, and estates

Gain of a foreign investor on the disposition of an interest in a partnership, trust, or estate is subject to tax under FIRPTA to the extent that the gain represents the investor's pro rata share of appreciation in the value of U.S. real property interests of the entity.

REITs

Distributions to foreign shareholders by a real estate investment trust (REIT) are treated as gains on the sale of U.S. real property to the extent of the shareholder's pro rata share of the net capital gain of the REIT on the disposition of U.S. real property interests. In the case of REITs controlled by U.S. persons, sales of the REIT shares by foreign shareholders are not subject to tax (other than in the case of distributions by the REIT).

Contributions to capital

Except to the extent otherwise provided in regulations, gain is recognized by a foreign investor under FIRPTA on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid in surplus or as a contribution to capital. The gain equals the fair market value of the property transferred over the adjusted basis of the property and any other gain recognized by the transferor.

Nonrecognition rules

FIRPTA authorizes the Secretary to prescribe regulations providing the extent to which nonrecognition rules of the Code will (or will not) apply to override its provisions. Regulations have not yet been issued. Pending the issuance of regulations, nonrecognition provisions generally apply, but only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (as modified by any treaty pursuant to Code secs. 894 and 7852(d)).

FIRPTA also authorizes the Secretary to prescribe regulations providing the extent to which transfers of property in reorganizations and changes in interests in (or distributions from) a partnership, trust, or estate are to be treated as sales at fair market value. Regulations have not yet been issued.

Reporting requirements and penalties for noncompliance

FIRPTA provides for enforcement of the tax on foreign investors through a system of information reporting designed to identify foreign owners of U.S. real property interests.

Reporting by U.S. RPHCs

U.S. corporations that are or, at any time during the preceding four years, were U.S. real property holding corporations (U.S. RPHCs) and that have one or more foreign shareholders at any time during the calendar year are required to file annual returns setting forth the name and address (if known by the corporation) of each foreign shareholder. The annual returns must also set forth any information with respect to transfers of stock in the corporation by foreign shareholders, as well as any other information, that the Secretary may prescribe. Any nominee holding stock in a U.S. corporation on behalf of a foreign person who does not furnish the above information is required to file such a return instead. No reporting with respect to publicly traded stock is required.

Proposed Treasury regulations provide that a domestic corporation whose stock is not publicly traded, any interest in which is known by the corporation to be held by a foreign person, must determine each December 31 (and on the acquisition or disposition of certain property) whether it is a U.S. RPHC (Prop. Treas. Reg. sec. 1.897-2(h)). When such a domestic corporation determines that it is not a U.S. RPHC, it must attach a statement to that effect to its income tax return for the year. The proposed regulations further provide that such a domestic corporation must, within 30 days after receipt of an inquiry from a foreign person holding an interest in it, inform that person whether his interest constitutes a U.S. real property interest and whether the corporation has submitted a statement to the Internal Revenue Service indicating that it is not a U.S. RPHC.

Reporting by foreign corporations and partnerships, trusts, and estates

Foreign corporations and partnerships, trusts, and estates (whether foreign or domestic) are required to file annual returns setting forth the name and address of each foreign person (and each U.S. person as well in the case of foreign corporations required to make a return) who has a substantial indirect investment in U.S. real property through the entity. The annual returns must also set forth such information with respect to the assets of the entity and such other information as the Secretary may prescribe. For this purpose, a person has a substantial indirect investment in U.S. real property through an entity if the person's pro rata share of the U.S. real property interests held by the entity exceeded

$50,000 at any time during the calendar year. In determining a person's pro rata share of the U.S. real property interests held by an entity, the entity must look through to the assets of any corporation in which the entity has an interest. U.S. real property interests held by a partnership, trust, or estate are treated as owned proportionately by the partners or beneficiaries. U.S. real property interests held by the spouse or a minor child of an individual are treated as owned by the individual.

Any entity required to make a return is also required to furnish each foreign person (and each U.S. person as well in the case of a foreign corporation required to make a return) holding a substantial indirect investment in U.S. real property through the entity a statement showing the name and address of the entity, the substantial indirect investor's pro rata share of the U.S. real property held by the entity, and such other information as the Secretary shall prescribe.

These reporting requirements do not apply to an entity for any calendar year in which the entity furnishes the Internal Revenue Service such security as the Service determines to be necessary to ensure that any U.S. tax with respect to U.S. real property interests held by the entity will be paid.

Reporting by certain other foreign investors

A separate reporting requirement applies to foreign investors owning U.S. real property who are not foreign corporations or partnerships, trusts, or estates required to report under the provision described immediately above. Where such a foreign investor did not engage in a trade or business in the United States at any time during the calendar year and held U.S. real property interests worth $50,000 or more at any time during the year, the foreign investor is required to file a return setting forth his name and address, a description of all U.S. real property interests held at any time during the calendar year, and such other information as the Secretary may prescribe.

In determining whether a foreign investor held U.S. real property interests worth $50,000 or more, a foreign partner or beneficiary of a trust or estate is treated as owning a proportionate share of the U.S. real property interests held by the entity. Also, U.S. real property interests held by the spouse or a minor child of a foreign investor are treated as owned by the foreign investor.

U.S. interest versus Virgin Islands interest

An investor taxed under FIRPTA is required to pay the tax and file the necessary returns with the United States in the case of interests in real property located in the United States, and with the Virgin Islands in the case of interests in real property located in the Virgin Islands. Sale of an interest, other than solely as a creditor, in a U.S. RPHC of the United States is subject to tax in the United States while sale of an interest in a U.S. RPHC of the Virgin Islands is subject to tax in the Virgin Islands.

Penalties for noncompliance

For each failure to file a return containing the information required by the above information reporting requirements or to furnish a required statement to a substantial indirect investor of its pro rata share of the U.S. real property interests held by an entity, a penalty is imposed of $25 for each day during which the failure continues, unless it is shown that the failure is due to reasonable cause and not to willful neglect. In the case of U.S. RPHCs, and of partnerships, trusts, estates, and foreign corporations through which there is substantial indirect investment in U.S. real property, the maximum penalty is $25,000 per calendar year. In the case of other investors subject to the reporting requirements, the maximum penalty for a calendar year is the lesser of $25,000 and five percent of the aggregate fair market value of the U.S. real property interests held by the investor at any time during the year.

Postponement of reporting requirements

Temporary and proposed regulations pertaining to the substantive and reporting provisions of FIRPTA were published in September 1982 (47 F.R. 41532 and 47 F.R. 41581). In April 1983, the Internal Revenue Service postponed the reporting requirements for 1980, 1981, and 1982 until after the issuance of final regulations. This postponement applied to all reporting-related deadlines including the deadline for applying for a security agreement in lieu of reporting. The Service decided to delay the reporting requirements rather than require immediate compliance with regulatory provisions that might be changed in response to public comment. In February 1984, the Service postponed the reporting requirements for 1983. The postponement of the reporting-related deadlines does not affect the obligation to file an income tax return if one is required or to pay any liability arising under FIRPTA.

In November 1983, the Service issued new proposed regulations pertaining to the substantive provisions of FIRPTA that supersede the proposed substantive regulations issued in September 1982 (48 F.R. 50751). The Service has not yet issued final regulations pertaining to the reporting provisions of FIRPTA.

Effective date

FIRPTA generally applies to dispositions after June 18, 1980. However, until January 1, 1985, gain generally is not taxed under FIRPTA to the extent required by treaty obligations of the United States. On and after January 1, 1985, FIRPTA generally will prevail over any conflicting treaty provisions remaining in effect except in certain situations where a treaty is renegotiated to resolve conflicts between the treaty and FIRPTA, and a new treaty is signed in 1981, 1982, 1983, or 1984. In that event, the delay in the effective date can be extended in the new treaty or in an accompanying exchange of notes beyond January 1, 1985, specifically for a period of up to two years after the signing of the new treaty. This two-year period is intended to permit the Senate adequate time to consider the new treaty.

The delayed effective date provision is intended to benefit only foreign investors who were residents on the date FIRPTA became effective of a country whose existing income tax treaty with the United States conflicts with FIRPTA. No benefit is intended for foreign investors who, after that date, rearrange their investment so as to come under such a treaty.

No step-up in basis is allowed with respect to a disposition of a U.S. real property interest to a related party (within the meaning of Code section 453(f)(1)) after December 31, 1979 in a transaction not otherwise taxed under FIRPTA either because it occurred on or before June 18, 1980 or was exempt from tax under a U.S. treaty obligation.

Congressional Efforts to Implement Withholding

FIRPTA presents compliance problems. Since the tax is not due until a tax return is filed after the end of the year, a foreign person can sell his U.S. real estate, take the proceeds out of the United States, and since he is beyond the jurisdiction of the United States, not pay U.S. tax on the sale. Moreover, through nominees and foreign corporations established in tax havens, he may be able to reinvest these untaxed proceeds back in the United States.

In addition, the FIRPTA information reporting system, as interpreted in temporary and proposed Treasury regulations (47 F.R. 41532 and 47 F.R. 41581), is cumbersome. As indicated above, the information reporting requirements of FIRPTA have been postponed by the Internal Revenue Service for 1980 through 1983, pending the issuance of final regulations with respect to those reporting requirements. The Internal Revenue Service has had difficulty developing these regulations; it has not yet issued final regulations, so no information reporting is now required.

To simplify the administration of FIRPTA, and to insure collection of the tax imposed, the Senate version of the FIRPTA legislation included a provision requiring withholding by purchasers of U.S. real estate, where a U.S. real property interest is acquired from a foreign investor. The conference on the 1980 legislation dropped this withholding provision. The Senate voted again in 1981, 1982, 1983, and 1984 to impose withholding on sales of U.S. real property interests by foreign investors. In 1981 and 1982, the conference committee did not agree to withholding. No conference was held on the 1983 legislation because the tax bill reported by the House Ways and Means Committee did not reach a vote in the House. As of the date of printing of this pamphlet, the conferees on the 1984 legislation (H.R. 4170) had agreed to a modified withholding proposal.

III. EXPLANATION OF THE BILL

Repeal of FIRPTA

S. 1915 would repeal the provisions of the Code (secs. 897, 6039C, and 6652(g)) added by FIRPTA that subject nonresident aliens and foreign corporations to tax on gains from dispositions of U.S. real property interests, and impose information reporting requirements in connection with such dispositions. Under the bill, such gains would no longer be subject to U.S. income tax unless, as before FIRPTA, they are effectively connected with a U.S. business or are realized by a nonresident alien individual who was present in the United States 183 or more days during the year.

Effective Date

The amendments made by the bill would apply to dispositions made in taxable years beginning after December 31, 1983 and to returns for calendar years beginning after December 31, 1983.

IV. ISSUES

Equity

One of the principal reasons cited by Congress in 1980 for the enactment of FIRPTA was that it was important to establish equity of tax treatment of U.S. real property between U.S. and foreign investors.[1] U.S. investors generally are taxable at graduated capital gain rates on all sales of U.S. real property interests. Prior to FIRPTA, foreign investors were taxable on sales of such interests only when their gains were effectively connected with a U.S. business or the investor was an individual who was present in the United States 183 days or more during the year. Most other types of passive income (e.g., rents, interest, and royalties) from U.S. sources paid to foreign investors generally are not exempt from U.S. tax. Prior to FIRPTA, foreign investors could obtain both the advantage of being taxed on current income from a U.S. real property interest on a net basis and the advantage of paying no U.S. tax on the eventual disposition of the property interest.

Proponents of FIRPTA contended that the ability of foreign investors to avoid capital gains tax on U.S. real estate dispositions put U.S. investors at a competitive disadvantage.[2] The differential treatment of U.S. and foreign owners of U.S. real estate arguably violated the principle of "horizontal" equity, i.e., that similarly situated taxpayers be subject to similar tax rules.

FIRPTA was also viewed as promoting international parity in the taxation of real property investments by foreigners. The tax codes of other countries generally subject U.S. investors to tax on capital gains realized on real property investments in those countries: A Treasury Department study of the tax treatment of foreign real estate investment in the United States found in 1979 that, ". . . nearly all other industrial countries, and virtually all of the developing countries for which the information is readily available, tax nonresidents on capital gain from the disposition of real property located in the country as well as on gains derived from business activity there." [3]

Advocates of FIRPTA repeal, however, argue that U.S. tax laws frequently violate the principle of treating similarly situated U.S. and foreign investors in a similar manner, and that it is unclear whether FIRPTA produces a more equitable result. The 1979 Treasury study cited included an analysis of a hypothetical investment in U.S. farmland which showed that if certain foreign investors were subject to a FIRPTA-type tax on capital gains, they would bear a heavier tax burden than similarly situated U.S. investors. The Treasury study found that the U.S. tax system tends to discriminate against foreign investments in assets which, as a result of debt financing or tax preferences, generate tax losses: If a foreign investor has no other effectively connected U.S. income, these tax losses would, to the extent that they are carried forward, result in no current reduction in tax liability. The Treasury study concluded that,

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[1] See H. Rep. No. 1167, 96th Cong., 2d Sess. 511 (1980).

[2] A General Accounting Office (GAO) study concluded in 1979 that, ". . . [E]limination of the tax advantage foreign investors have would remove a factor that may be preventing potential U.S. purchasers from competing effectively with potential foreign purchasers." See GAO, *Foreign Investment in U.S. Agricultural Land—How it Shapes Up*, (July 30, 1979), p. iii.

[3] Treasury Department, *Taxation of Foreign Investment in U.S. Real Estate*, (May 1979), p. 60.

> Some differences (e.g., treatment of capital gains, taxation limited to effectively connected and specified other U.S. income) favor foreign taxpayers, others (e.g., treatment of losses, number of exemptions) favor domestic taxpayers. Whether foreign taxpayers are better or worse off than domestic taxpayers when all the differences are considered together depends on the circumstances of a particular investment and investor. (p. 51).

Some advocates of FIRPTA repeal have also questioned the legislation's equity effect on the ground that capital gains in assets other than real property, such as bonds and listed securities, are not generally subject to U.S. tax. They allege that FIRPTA was not intended to improve the equity of the U.S. tax system but instead to deter foreign investment in U.S. real estate.

Enforceability

Another issue is the extent to which FIRPTA can be adequately enforced. Under its information reporting requirements, tax and returns are not due until after the end of the year. While most practitioners believe that the vast majority of foreign investors will pay their U.S. tax, some foreign investors might sell their U.S. real property, take the proceeds out of the United States before the end of the year, and not pay the tax due. Also, the information reporting requirements have not yet gone into effect; the Internal Revenue Service has postponed their application pending the issuance of final regulations. The Service has had difficulty in developing the regulations. A withholding system might simplify the administration of FIRPTA and insure collection of the tax more effectively than information reporting alone. In 1980, 1981, and 1982, withholding proposals were approved by the Senate but rejected by the House-Senate Conferences. As of the date of the printing of this pamphlet, however, the House and Senate conferees on H.R. 4170 had agreed to a modified withholding proposal.

Foreign Demand for U.S. Real Property

FIRPTA imposes tax on capital gains realized by foreign investors on U.S. real property investments in situations where, prior to FIRPTA, tax might have been avoided. Consequently, FIRPTA lowers the prospective after tax rate of return on foreign investments in U.S. real property which is likely to reduce foreign demand. Thus, FIRPTA tends to reduce the aggregate (i.e., domestic plus foreign) demand for U.S. real property and, therefore, lower its price. This hurt U.S. real estate owners whose asset values may be diminished.

While the enactment of FIRPTA may have reduced the demand for U.S. real property, the following factors suggest that the overall magnitude of such an effect is negligible. First, although the data are incomplete, foreign investment appears to constitute only a small portion of total investment in U.S. real property. The Department of Agriculture estimates that foreigners own 1.1 percent of the privately owned agricultural land in the United States.[4] A General Accounting Office (GAO) study found that, from January 1977 through June 1978, only 4 percent of the agricultural land sold in 10 States was purchased by foreign investors. Data from the department of Commerce covering new plant and equipment investment, but excluding land, show that foreign investment amounted to 7.2 percent of total U.S. nonfarm expenditures for new plant and equipment in 1981.[5] Although there is no definitive data, it would appear that foreign investment amounts to less than 10 percent of U.S. real property investment. Thus, if the enactment of FIRPTA caused foreign real property investment demand to decline by, for example, 20 percent, the effect on aggregate real property investment demand would be below 2 percent.

Second, the GAO's informal survey of foreign buyers' purchase motives suggested that confidence in the U.S. political and economic system, a desire to hedge against inflation and devaluation in foreign currencies, and the low price and high availability of land were at least as important as tax considerations in the decision to invest in the United States.

Trade Balance

Currently, the United States follows a policy of flexible exchange rates under which the market is allowed to set the value of the dollar relative to other currencies based on supply and demand, rather than having the government attempt to peg the value of the dollar at a particular level. In a regime of flexible exchange rates, net capital inflows strengthen the dollar. A stronger dollar reduces the dollar price of imports into the United States and makes our exports more expensive to foreign purchasers. Thus, a stronger dollar tends to reduce exports and increases imports. Consequently, if repeal of FIRPTA increases net foreign investment in the United States, there is likely to be additional dollar appreciation, and a decline in net exports. Thus, the benefits of increased foreign real property investment in the United States attributable to FIRPTA repeal might be offset by reduced income and employment in the exporting and import-competing sectors of the economy. However, as discussed in the previous section, it is unlikely that the foreign demand for U.S. real property investment is very sensitive to tax considerations. Furthermore, real estate investment constitutes only a small portion of total foreign investment in the United States. Commerce Department data show that *direct* foreign investment in the United States (that is, plant, equipment, land, and inventories only) amounted to less than 12 percent of *total* foreign investment in the United States in 1982–83. Thus, repeal of FIRPTA would likely have only a negligible effect on net foreign investment in the United States and the U.S. balance of payments.

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[4] U.S. Department of Agriculture, *Foreign Ownership of U.S. Agricultural Land Through December 31, 1983,* (April 1984).

[5] U.S. Department of Commerce, *Survey of Current Business,* (November 1983).

Revenue Impact

Although repeal of FIRPTA is likely to cause only a negligible increase in foreign investment in U.S. real estate, the loss in revenue to the U.S. Treasury would be significant, especially in view of the large current and projected Federal budget deficit. In 1979, the Treasury Department estimated that the revenue increase associated with a FIRPTA-type tax would be approximately $226 million for 1979. The annual loss in revenue were FIRPTA repealed today would probably exceed this amount because of inflation and greater foreign investment in U.S. real property.

Based on the analysis of foreign demand for investment in U.S. real property that appears above, it is unlikely that the reduction in tax resulting from FIRPTA repeal would significantly increase the level of foreign investment.

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STATEMENT OF SENATOR MALCOLM WALLOP

The purpose of this hearing today is to receive testimony on S. 1915, a bill introduced by Senator Goldwater which would repeal the Foreign Investment in Real Property Tax Act of 1980. In 1979, I introduced the legislation which, as it wound its way through the legislative process, became the Foreign Investment in Real Property Tax Act or FIRPTA. Since the bill's enactment in 1980 the effort to develop effective regulations has proven to be a very complicated and frustrating process. And indeed, there is some question whether the final version of the law was so broad in its coverage that we are on the verge of driving a substantial amount of foreign investment capital from our shores, at a time when the need for that capital is apparent to everyone.

In introducing S. 208 back in 1979, I highlighted the very distinct tax advantage a foreign investor had over an American taxpayer when it came to purchasing and profiting from the purchase of American farmlands. As important was the possible impact that tax advantage would have on the prices of that farmland. Clearly, if one investor has a tax advantage over another with respect to any particular investment, the tax advantaged investor can obviously afford to pay more for the investment, in this case farmland. My intent in introducing the FIRPTA legislation was to equalize the tax treatment afforded investments in farmland and remove the opportunity the unequal tax treatment may have created for foreign investors to speculate in U.S. agricultural lands. My intent extended no further than that, but the impact and coverage of FIRPTA may well have.

The purpose of Senator Goldwater's legislation is to repeal the entirety of FIRPTA. I can not tell the Senator that I am ready to cosponsor his legislation, but I think he has raised some very real issues which I think deserve this Committee's full attention. Clearly, I would feel reluctant at this point to advocate repeal of FIRPTA as it effects farmlands, but with respect to other investments covered by FIRPTA the case for repeal may be more apparent. I look forward to comments of the witnesses scheduled to appear before the Committee this morning.

Senator WALLOP. Good morning. The purpose of our hearing today is to receive testimony on S. 1915, a bill introduced by my friend, Senator Goldwater, which would repeal a Foreign Investment in Real Property Tax Act of 1980, otherwise known as FIRPTA.

In 1979, I introduced the legislation which, as it wound its way through the legislative process, became FIRPTA. Since the bill's enactment in 1980, the effort to develop effective regulation has proven to be very complicated, and a frustrating process. And, indeed, there is some question whether the final version of the law was so broad in its coverage that we are on the verge of driving a substantial amount of foreign investment capital from our shores at a time when the need for that capital is apparent to nearly everyone.

In introducing S. 208 back in 1979, I highlighted the very distinct tax advantage a foreign investor had over an American taxpayer when it came to purchasing and profiting from the purchase of American farmlands. As important was the possible impact the tax advantage would have on the prices of that farmland. Clearly if one investor has a tax advantage over another with respect to any particular investment, the tax advantage investor can obviously afford to pay more for the investment than in the case we were interested in that was farmland. My intent in introducing the FIRPTA legislation was to equalize the tax treatment afforded investments in farmland or agriculture land, and remove the opportunity the unequal tax treatment may have created for foreign investors to speculate in U.S. agricultural land.

My intent extended no further than that. But the impact and coverage of FIRPTA has. I might say—and it's rare that anyone will see a Senator second-guess his previous positions on things—that my feeling is that many in American agriculture today would welcome some competition for that farmland inasmuch as the price of the farmland has declined by 25 to 30 percent over the past year. And that is what has sustained many of us in agriculture in our pursuit of the dream that it would one day turn profitable.

The purpose of Senator Goldwater's legislation is to repeal the entirety of FIRPTA. And I cannot tell my colleagues that I am ready yet to cosponsor this legislation, but I think he has raised some very real and very credible issues which deserve this committee's full attention.

Clearly, I would feel reluctant at this point to advocate the entire repeal of FIRPTA, although it is a thought that is occurring to me. I think it's a situation where you have to look at the entirety of a circumstance as it exists today over the entirety of the circumstance as it existed when I introduced it.

I look forward to the comments of the witnesses scheduled to appear before the committee this morning. The issues raised are genuine, and the issues raised need the attention of the Nation. And I welcome most warmly my colleague Senator Goldwater.

STATEMENT OF HON. BARRY GOLDWATER, U.S. SENATOR FROM THE STATE OF ARIZONA, ACCOMPANIED BY J. TERRY EMERSON, COUNSEL

Senator **Goldwater**. Thank you very much, Mr. Chairman. And I must apologize for having to leave early because we are continuing with that little thing that you and I spent until 2 this morning. And you are probably as tired as I am.

Senator **Wallop**. You are going to let me go to sleep in front of all these people while you just prance out of here looking fresh this morning.

Senator **Goldwater**. I think I can make it. [Laughter.]

Thank you very much, Mr. Chairman, for your hearing on S. 1915, the bill I have introduced to repeal FIRPTA, the Foreign Investment in Real Property Tax Act of 1980.

Mr. Chairman, I joined you in introducing the bill which was aimed originally at preventing foreign takeovers of farm production land. However, the concept of the bill was completely changed at the urging of the Treasury Department so that FIRPTA is no longer limited just to crops and pasture land or to orchards and vineyards, as we intended.

The new statute applies not only to direct investment in real property of all kinds, but to stock interests in any U.S. manufacturing and production firm in which a foreign investor holds more than 5 percent of that company's stock. Thus, the law strongly discourages investment that may increase the competitiveness of U.S. industries and create more U.S. jobs. It is a major disincentive to foreign investment in small oil and gas exploration companies and is depriving them of financial support needed to search for energy reserves.

Now, Mr. Chairman, two basic arguments have been raised in defense of FIRPTA. One is that foreigners would gain control of American farm production. The other is that foreign people should be taxed the same as American citizens are.

Both arguments, in my mind, are fallacious. First of all, foreign ownership of American farm and ranch land is and has been extremely small. At the end of 1983, it totaled less than one-half of 1 percent of all privately held agricultural land in the United States, fewer than 5 million acres. And putting a tax impediment on the flow of capital into agriculture at a time when the market for farmland is soft and real interest rates are high hurts farmers instead of helping them.

If any law is needed to limit foreign ownership of agricultural land, the States have shown themselves capable of looking out for themselves. In fact, 30 States already have adopted some type of law restricting alien ownership of real property, including farmland. Some of these States impose acreage limitations on foreign investment to ensure that no single nonresident alien investor could become dominant in any particular area. Other States put a limit on the number of years a foreign investor can hold land.

Another point I would like to make is that foreign investors will not be given privileged tax treatment if FIRPTA is repealed. The present law discriminates against foreign investors who cannot benefit from depreciation writeoffs and other tax benefits available to U.S. citizens.

Finally, I believe FIRPTA is blocking hundreds of millions of dollars of investment money that is needed in this country. New foreign direct investment was $16 billion lower last year than it was in 1981. Much of this money has moved into other countries and I believe that FIRPTA can be blamed for a large part of this declining investment.

Mr. Chairman, I will now introduce the three very distinguished witnesses who have joined me today. These gentlemen are appearing in their own rights as expert witnesses and are not representing any clients.

The first to speak will be W. Donald Knight, Jr., who is a partner in the law firm of King & Spalding in Atlanta, GA. Mr. Knight is head of that firm's international department and is author of a book, "Structuring Foreign Investment in United States Real Estate," which was published last year. He is a member of the Editorial Advisory Board of Tax Management International Journal.

Next you will hear from Mr. Timothy D. Richards, who is a partner in the law firm of Corrigan, Zelman & Bander in Miami, FL. Mr. Richards' law firm does about 98 percent of its business in foreign investment law and he, too, has written a book on the subject. It is entitled "The Guide to Foreign Investment in United States Real Estate," and was published this year. And Mr. Richards has been an assistant editor of the International Tax Journal.

The third expert witness is Dr. Jimmye Hillman, who is chairman of the Department of Agricultural Economics at the University of Arizona in Tucson. Dr. Hillman has been with the university for 34 years and has served as head of the department for 22 years. He is well known nationally and has been asked by presidents of both parties to assist in solving farm problems.

Mr. Chairman, I will turn the microphone over to these gentlemen, starting with Mr. Knight, but first, I have a question here, if you don't mind. I wonder what you would think if FIRPTA would be repealed for everything but cropland, pasture, orchards, and vineyards. Maybe we can compromise, if a compromise was in the offering.

Senator **Wallop**. Barry, that's too loud for people who were up until 2.

I'm willing to entertain anything. I have an entirely open mind. It occurs to me that it's not an unusual situation in politics to find a motion-driving solution that sometimes don't, in fact, provide the solution that we often hoped that it would. It may be—and I would hope before we hear from others—might be willing to weigh in on the side of its entire repeal. I don't know. But I think it's worth keeping that option open as we proceed.

But, clearly, I feel a little bit as though I sat here as a son who was kidnaped and returned as a gorilla. [Laughter.]

And I really didn't want it back that badly. So I really—it may be that that's the solution. It may be that its entire repeal is the solution. It may be a combination of things. But I salute you for identifying a problem which neither of us intended to happen.

Senator **Goldwater**. I'm not here to——

Senator **Wallop**. Is that right? [Laughter.]

Senator **Goldwater**. It seems to have become a way of life.

Senator **Wallop**. I think we want to hear. And I think there are other witnesses that could weigh in on this issue now that the motion has been swung in something of a different direction. Our friends in agriculture have been suffering badly for the last few years. One of the worst things has been the declining value of their croplands where there is less competition for it than is healthy.

Senator GOLDWATER. Thank you very much, Mr. Chairman. And I do apologize for having to leave.

Senator WALLOP. I will send somebody down there to make sure you went to the floor and not to bed. [Laughter.]

[The prepared statement of Senator Goldwater follows:]

Statement of Senator Barry Goldwater
Before the Senate Finance Committee

FIRPTA Repeal Will Sustain Economic Recovery

June 19, 1984

Mr. Chairman, I thank you very much for your kindness in scheduling a hearing on S. 1915, the bill I have introduced to repeal FIRPTA, the Foreign Investment in Real Property Tax Act of 1980. I also appreciate the willingness of Senator Wallop, the author of FIRPTA, to hold this oversight hearing to review how the law has worked now that it has been on the books for a few years and to examine whether it has carried out the intent of its authors, whether it has had unintended harmful effects and whether it may have been unnecessary.

Mr. Chairman, I should point out that I joined the Senator from Wyoming in introducing his bill, which as originally written was aimed at preventing foreign takeovers of farm production land. However, the concept of the bill was completely changed at the urging of the Treasury Department, so that the final version was an all-inclusive reporting and capital gains tax applicable to foreign investment in real estate of all kinds. FIRPTA is not limited just to crop and pasture land or orchards and vineyards, as we first intended.

Instead, the new statute applies not only to direct foreign investment in real estate, but to stock interests in any U.S. manufacturing and production firm in which a foreign investor holds more than five percent of that company's stock. Thus, the law strongly discourages investment that may increase the competitiveness of United States industries and create more United States jobs. It is a major disincentive to foreign investment in small oil and gas exploration companies and is depriving them of financial support needed to search for energy reserves. This is obviously contrary to our national interests.

Since FIRPTA was enacted several comprehensive government studies have been made of the extent and impact of foreign investment in the United States and of state laws applicable to these investments.[2] With the benefit of the tremendous amount of new data that is currently available to us on the subject and that no one possessed when Congress wrote FIRPTA, we can now see clearly that the emotional fears expressed about possible foreign domination of American farmland and other real estate were based on a myth. We now know that foreign investors are helping to speed along the healthy economic recovery our nation is enjoying.

Mr. Chairman, two basic arguments have been raised in defense of FIRPTA. One is that foreigners would control American farm production. The other is that foreign people should be taxed the same as American citizens are.

Both arguments are fallacious. First of all, foreign ownership of American crop, grazing and other production land is and has been miniscule. At the end of 1983, it totaled only 0.4% of all privately held agricultural land in the United States. When partial interests are taken into account, foreign owned production acreage drops even further.[3]

Nor have foreigners diverted farmland to other purposes to any substantial degree.[4] In fact, foreign landholders have added thousands of acres to agriculture and usually have kept farmland in the same kind of production it was in before they purchased it.[5] When foreigners do sell U.S. land, it generally returns to U.S. citizen ownership.[6] Further, in many cases foreign investors purchase farm machinery, irrigation equipment and the like for U.S. farms which could not have been bought by the former U.S. owner. These purchases, plus the employment of local farm workers by absentee foreign owners, benefit local economies.

Mr. Chairman, according to a report just issued by the U.S. Department of Agriculture, 30 states have some type of law restricting alien ownership of real property, including farmland.[7] Some of these states impose acreage limitations on foreign investment to ensure that no single non-resident alien investor could become dominant in any particular area.[8] Other states put a limit on the length of time property can be held by a foreign investor.[9]

The point I am making, Mr. Chairman, is that if any law is needed to limit foreign ownership of agricultural land, the several states can and will address the subject themselves.[10] FIRPTA is not needed for this purpose. Putting a tax impediment on the flow of capital into agriculture at a time when the market for farmland is soft and real interest rates are high is detrimental, not helpful to farmers. When asset values are low, farmers must pay their debts from net income, something many of them do not see for years in a row.

The second point I would like to make is that foreign investors would not enjoy privileged tax treatment if FIRPTA were repealed. The present tax law discriminates against foreign investors, who in the nature of things cannot benefit from depreciation write-offs and other tax benefits easily available to U.S. citizens.[11]

Thirdly, I am convinced that FIRPTA is blocking hundreds of millions of dollars of investment money that is needed in this country. According to the U.S. Department of Commerce, which collects complete data on a fiscal year basis of all foreign direct investment in the United States, non-bank foreign land holdings increased by 4.8 million acres in 1981,[12] but in 1982 new investment fell to 1.6 million acres and in 1983 it dropped all the way down to 360,000 acres.[13] New foreign direct investment fell $16.2 billion from 1981 to 1983.[14]

Yet, at the same time, foreign portfolio investment increased. According to balance of payments data collected by the Department of the Treasury, foreign persons bought a net amount of $5.1 billion of U.S. stocks in 1981. This rose to $6.4 billion in 1983.[15] The stronger dollar and lingering recession abroad cannot be used as the excuse for falling new foreign investment in real estate when foreign stock purchases have climbed more than a billion dollars in the same period. There is no capital gains tax on the sale of regularly traded stock by foreign investors, unless an investor owns more than five percent of the total shares or the companies are real property holding corporations. But FIRPTA imposes such a tax on foreign real property investment and this may explain why new foreign land investment has fallen so dramatically.

In closing, Mr. Chairman, I want to point out the great lengths to which other nations are going to attract investment. I offer for the record a short paper prepared by the Library of Congress describing newly established immigration practices used by many foreign governments to win foreign investment. Unlike our immigration laws, which place investors at the bottom, governments in Australia, Canada, the Philippines, Singapore and Thailand are offering priority status to aliens who will agree to make sizeable investments in local enterprises.

As long as the United States continues to suffer large budget deficits, I think we should join those nations of the world that are doing everything possible to woo foreign investment. By repealing FIRPTA, I believe we will strengthen every state in the union that wants additional investment in their local economies.

Mr. Chairman, I will now introduce the three distinguished witnesses who have graciously agreed to join me today in order to offer you their expert opinions as to why FIRPTA should be repealed. I should mention that these gentlemen are appearing in their own right and are not representing any clients today.

The first to speak will be W. Donald Knight, Jr., who is a partner in the law firm of King & Spalding in Atlanta, Georgia. Mr. Knight is head of that law firm's international department and is author of a book, Structuring Foreign Investment in U.S. Real Estate, which was published last year. He is a member of the Editorial Advisory Board of "Tax Management International Journal".

Next, you will hear from Mr. Timothy D. Richards, who is a partner in the law firm of Corrigan, Zelman and Bander in Miami, Florida. Mr. Richards' law firm does about 98% of its business in foreign investment law and he, too, has written a book on the subject. It is entitled The Guide to Foreign Investment in U.S. Real Estate and was published this year. Mr. Richards has been an assistant editor of the International Tax Journal.

The third expert witness is Dr. Jimmye Hillman, who is Chairman of the Department of Agricultural Economics of the University of Arizona in Tucson. Dr. Hillman has been with the University for 34 years and has served as head of the department for 22 years. He is well known nationally and has been sought out by Presidents of both parties to assist in solving major farm problems.

FOOTNOTES

1. Two examples will illustrate the harmful effects of FIRPTA on the American economy:

a. A U.S. corporation involved in production and sale of plastic chemical products may wish to enter into a joint venture with a foreign plastic products corporation under which the U.S. corporation would offer a part of its stock (exceeding 5%) in exchange for know-how and production rights for certain products. The foreign corporation considers the potential return on its investment in the U.S. corporation and determines that under current U.S. law it would be subject to capital gains taxation on the disposition of its investment in the U.S. firm. Therefore, the foreign corporation decides not to proceed with the transaction resulting in denial to the U.S. corporation of the benefits of the foreign corporation's technology and production rights, which would have increased the competitiveness of the U.S. corporation and created more U.S. jobs.

b. A foreign corporation engaged in paper manufacturing and processing may wish to invest in a U.S. firm engaged in timber and pulp manufacturing to produce paper products for U.S. consumption and export to other countries. While investigating the potential return on such an investment, the foreign corporation determines that under FIRPTA disposition of the stock in a U.S. timber, pulp and paper producer would subject the foreign firm to capital gains tax. The foreign company is discouraged from investing in the U.S. business, thus losing jobs in the U.S. and reducing the prospect of expanding exports of these products.

2. See especially U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, 1980*, (published Oct. 1983), benchmark survey required every five years pursuant to International Investment Survey Act of 1976, P.L. 94-472, 90 Stat. 2059; U.S. Department of the Treasury, *Foreign Portfolio Investment in the United States as of December 31, 1978*, (published Dec. 1980), benchmark survey required every five years by P.L. 94-472; and the U.S. Department of Agriculture annual reports on foreign ownership of U.S. agricultural land submitted in compliance with the Agricultural Foreign Investment Disclosure Act of 1978, P.L. 95-460, USC 3501-08.

3. Less than five million acres of cropland, pastureland, orchards and vineyards are foreign owned compared with 1.3 billion acres of privately owned agricultural land in the United States. Parcels which are owned only in part by foreign investors represent 11% of land holdings of foreign owners and a proportionate reduction has been made in calculating the above total. It should be noted that 57% of foreign owned agricultural land is timber or forest land and is not included in the total. J. Peter DeBraal and T. Alexander Majchrowicz, *Foreign Ownership of U.S. Agricultural Land Through December 31, 1983*, U.S. Department of Agriculture Natural Resource Economics Division, (April 1984), at pp. 8, 21, 23 (table 11, total all landholdings).

4. According to the 1983 report of the U.S. Agriculture Department, foreigners do not appear to be taking farmland out of agricultural production "in any substantial degree." The report states: "No change in intended use was reported for 92 percent of the acres . . . Intended use changes to other agricultural usage were reported for holders of 2 percent of the acres." Id., at 27.

5. In 1983 alone, foreign landholders added 1,614 acres into agriculture and took only 335 acres out of agriculture, for a net gain of 1,279 acres. Id., at 43.

6. Transfers of U.S. agricultural land by foreign investors to known foreign persons totaled only 23,887 acres in 1983, 10% of dispositions made by foreign owners in that year. Id., at 45.

7. See generally, comprehensive summary of state laws presented state-by-state in Dale C. Schian, State Laws Relating to the Ownership of U.S. Agricultural Land by Aliens and Business Entities, U.S. Department of Agriculture, Natural Resource Economic Division, (May 1984). See also, discussion of state restrictions on foreign ownership of agricultural land in Neil Harl, Agricultural Law, Vol. 13, Matthew Bender, N.Y.C. (1983), at Chapter 23.

8. E.g., statutes of Pennsylvania, South Carolina, South Dakota and Wisconsin. D. Schian, id., at 57, 59, 60, 65.

9. E.g., statutes of Indiana, Iowa, Kentucky, Mississippi, Nebraska and Oklahoma. D. Schian, id., at 14, 24, 32, 38, 53.

10. In addition to laws in 30 states restricting alien ownership of land, 17 states require foreigners to report land they own in those states or monitor foreign investment by using the same data collected by the United States. D. Schian, id., at 3.

According to Dr. Neil E. Harl, author of a multi-volume treatise on agricultural law: "The right of a sovereign state to restrict land ownership by aliens is deeply imbedded in the law of the United States." Harl, supra note 7, at 123-23. In the few cases in which state limits on foreign ownership of farmland have been challenged, they were upheld as constitutional exercises of state police power. Insofar as such laws apply to nonresident aliens outside the territory of a state, the restrictions need satisfy only the traditional "rational state policy" standard and not the stricter "compelling state interest" test sometimes used in cases brought under the due process or equal protection clause of the Fourteenth Amendment. Shames v. Nebraska, 323 F. Supp. 1321, 1335 (D. Neb. 1971), aff'd. on appeal, 408 U.S. 901 (1972); Lehndorff Geneva, Inc. v. Warren, 74 Wisc. 2d 369, 246 NW. 2d 815, 824-825 (1976).

11. There are two categories of foreign investors, those doing business and those not doing business in the United States. Foreign investors doing business have always been taxed the same as U.S. citizens

both on their income and capital gains. However, FIRPTA has imposed on them onerous reporting and disclosure requirements that are not placed on U.S. citizens.

Foreigners investing in the nonbusiness category have the disadvantage of paying a flat 30% tax based on gross income without any of the deductions or exemptions available to U.S. citizens. If a real property investment produces income from rentals, for example, a 30% tax based on the gross rentals would be paid without deducting any expenses, such as property taxes and mortgage interest payments. Under FIRPTA, these investors suffer twice, continuing to pay an equal income tax while they hold the property and a capital gains tax upon disposing of the property.

Another discrimination against foreigners results from the fact that a domestic investor can usually offset other U.S. income with depreciation and other paper losses arising from his investment in commercial real property. The foreigner cannot take advantage of these tax shelters because he does not have other U.S. income to offset.

12. In 1980, nonbank U.S. business enterprises in which there is foreign direct investment, including larger individual landholders, owned 9,552,000 acres of land in the United States. In 1981, the total acres so owned had climbed to 13,134,000. Ned G. Howenstine, "U.S. Affiliates of Foreign Companies: Operations in 1981," U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business (November 1983), at 24-25.

13. In 1982, foreign direct investors sharply reduced outlays to acquire or establish U.S. business enterprises. Outlays by foreign direct investors fell from $23.2 billion in 1981 to $10.8 billion in 1982. U.S. businesses acquired by foreigners in 1982 owned 1,012,480 acres and U.S. businesses established by foreigners in 1982 owned 587,442 acres. R. David Belli, "U.S. Business Enterprises Acquired or Established by Foreign Direct Investors in 1983," U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business (May 1984), at ___.

14. In 1983, foreign investors' spending to acquire or establish U.S. businesses declined for the second consecutive year. Foreign investors spent $7 billion in 1983 to acquire or establish U.S. businesses, including real estate companies, a drop of $3.8 billion from 1982. Foreigners acquired U.S. businesses owning 130,761 acres in 1983 and established U.S. companies holding 226,835 acres in 1983. D. Belli, id., at ______.

15. Source: U.S. Department of the Treasury, Office of Data Management, Office of Assistant Secretary for International Affairs.

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

June 11, 1984

TO : Honorable Barry Goldwater
363 Russell Office Building
Attention: Mr. Terry Emerson

FROM : Marjorie Niehaus, M.N. Analyst in Asian Affairs
Foreign Affairs and National Defense Division

SUBJECT : Selected Governments' Immigration Regulations for Investors

In response to your request of May 9, 1984, and our subsequent phone conversations, I am forwarding information about selected governments' immigration practices for investors. The following information was obtained during June 1984, in phone conversations with diplomatic representatives of the respective embassies.

Australia -- A Business Migration Program offers permanent resident status to an investor and dependents who invests about 250,000 Australian dollars in the establishment of a business in Australia which either introduces new technology or provides significant employment opportunities for Australians. The investor must personally settle in Australia. Contact: Neil McCann 797-3278.

Canada -- Priority immigration categories are: family reunification and humanitarian cases; persons with designated occupations; and business entrepreneur and self-employed persons. Criteria for the third category include: that a viable business be established in which the entrepreneur takes an active development role; and that it provides at least one more job than his. No specific financial amount is designated. Local authorities have input into final approval. Contact: Bill Lundy 785-1400.

Philippines-- A $100,000 investment in a designated industry approved by National Investment Board conveys eligibility for permanent resident status to the investor and dependents. (Please note that peso was recently devalued so the investment requirement might be modified.)

Singapore-- $1 million held in escrow by Economic Development Board entitles an investor and three dependents to permanent residence. Written information is being mailed from New York office which CRS will forward.

Thailand--Regulations have been put in effect within last 10 months. Investors and dependents can obtain permanent residence status if they make one of three types of direct investments: 1) direct investment of $10 million baht (23 baht = $1) in a new project; 2) funds invested in ordinary company shares exceeding 25 percent of total registered capital of the company; 3) purchase of government bonds -- 8 million baht per investor, 6 million baht for spouse, and 2 million baht for each minor dependent. CRS will forward written information being mailed from the New York office.

STATEMENT OF W. DONALD KNIGHT, JR., KING & SPALDING, ATLANTA, GA

Senator WALLOP. Mr. Knight.

Mr. KNIGHT. Thank you, Mr. Chairman.

I appreciate Senator Goldwater's invitation to appear today and the committee's granting me the opportunity to speak to the question of whether FIRPTA should be repealed.

Since the adoption of FIRPTA there have been approximately 70 articles written in various tax and other professional journals which describe the problems and inconsistencies found in the FIRPTA law, itself. It's not my purpose today to speak to those problems and inconsistencies of a technical nature. Rather, what I would like to convey today to you is my very strong conviction that FIRPTA should be repealed as a matter of the economic best interests of this country.

The revenues produced and projected to be produced by FIRPTA in the context of the budget of the Federal Government a mere pittance. This morning we had given out to us at this hearing a publication apparently prepared by the Joint Committee on Taxation. That publication on today's hearing states that the Treasury report of 1979, prepared before the enactment of FIRPTA, indicated that the projected revenues from FIRPTA in 1979 would be $226 million. Somehow or other there is an error there. Table 5-1 of the Treasury report indicates that a FIRPTA-type capital gains tax applicable to all real estate in 1979 would have produced a mere $142 million of additional revenue for the Government. There is another figure in that chart saying $276 million would be produced for 1979 if capital gains tax applied to all foreign direct investment, not just real estate. Apparently the joint committee picked up that number. But $142 million, I submit, while not a small amount of money, is a small amount of money in context of the budget of the United States.

On May 1 of this year, Ronald Pearlman, Deputy Assistant Secretary for Tax Policy of the Treasury Department, appeared before the House Ways and Means Committee to indicate the administration's strong support for an immediate repeal of the existing withholding tax on portfolio interest paid to foreign investors.

Page 15 of Mr. Pearlman's statement indicated that the administration would like to emphasize its support for repeal of that tax never depended on whether or not the repeal of withholding would produce a revenue gain or loss to the U.S. Government Treasury, but rather that the administration's support was being given as a matter of economic policy of this country.

It seems to me that this kind of analysis should be made here in the considerations of whether FIRPTA should be repealed. There is clearly a need and a desirability for foreign portfolio investment in this country, and it should be encouraged, I think with Mr. Pearlman, by repeal of the withholding tax.

However, there is a difference between the kinds of investment produced in the portfolio context and the kind of investment produced when a foreign investor invests in U.S. real property. We only have to look at the recent example of Continental Illinois Bank to realize that foreign investors who invest in portfolio securities in this country are in a position to vote with their feet. Widely publicized reports indicate that when foreign investors became frightened, they moved their money and substantially accelerated the problems of that bank. I think the lesson is clear.

By contrast, virtually without exception, foreign investment in U.S. real estate is long-term, illiquid investment that gives foreign investors a genuine stake in the well-being of our country. FIRPTA has had the effect of discouraging this kind of desirable foreign investment. Indeed, in early seminars where FIRPTA was discussed, it was referred to quite frequently as the Hot Money Encouragement Act of 1980, because of its inclination to cause foreign investors to choose other types of investments in the United States, such as portfolio investment, over the more permanent type of investment of real estate.

It's my belief that FIRPTA should be repealed on this ground of economic policy alone.

However, I also believe the basic premise behind FIRPTA is a fallacy. As Senator Goldwater has indicated, the basic premise behind FIRPTA's adoption was that there should be tax equity, that U.S. investors in real estate should be treated the same as foreign investors in real estate, that there should be a capital gains tax applied to both.

On the surface, this argument has real appeal. It sounds fair. It sounds reasonable. The problem is that one cannot look at a real estate investment on the surface and give a fair assessment of whether taxation is equal in the case of U.S. investors as compared to foreign investors. Capital gains taxation is only one part of the story.

In the Treasury's own report issued in 1979, there is a graph that is reproduced in the written materials that I have submitted to you. It indicates that the economic benefit difference between a pre-FIRPTA foreign investor exempt from capital gains tax in a hypothetical farm investment and a domestic investor who was subject capital gains tax is miniscule. However, when the FIRPTA tax is imposed, the graph shows that the foreign investor suffers a real disadvantage, compared to the U.S. investor. The reason for this is clear. A U.S. investor, as Senator Goldwater has said, is in a position to take advantage of tax shelter generated by real estate investment in this country against that U.S. investor's other passive income. Generally speaking, a foreign investor is not in a position to do so. The Treasury's report contains what seems to me——

Senator WALLOP. Mr. Knight, could I just interject a question there because I think it is necessary?

Mr. KNIGHT. Surely.

Senator WALLOP. It is one thing to talk about investors in the abstract, people who invest in farmland or agriculture. It's another thing to talk about people whose business it is, who frequently don't have any income to shelter.

If you can sort of touch both of those. That was our original purpose. Dealing with people whose livelihood was agriculture.

Mr. KNIGHT. Quite frankly, I was surprised at the time to see the Treasury graph and to see that it did produce virtually the same economic results for foreign investors, compared to domestic investors in farmland. That example did, as you suggest, assume that the U.S. investor had other income which could be sheltered. That in the case of farmland investment may not be an accurate assumption.

And as far as I am concerned and as far as the bulk of foreign investors are concerned, I think that FIRPTA is not a problem in the area of farmland investment, because farmland investors typically are holding their farmland investments here for a very long term. I have had a foreign investor sit in my office and I began to tell him, before FIRPTA was enacted, how he could structure the investment in a way that would avoid the U.S. capital gains tax if he ever chose to sell the farm. And I noticed he was getting redder and redder in the face. And he rose to his full, considerable height, and said to me, "Mr. Knight, we are not sellers." In short, I don't think the capital gains tax applicable to agricultural property under FIRPTA is a serious problem for foreign investors.

What I think is much more a problem is the inequity that exists between foreign investors in developed properties where much more tax shelter is generated and much more tax shelter is typically used against passive income of U.S. investors who invest in this type of property.

Generally speaking, a foreign investor, because there is a totally different set of tax rules applicable to foreign investors as compared to U.S. investors, cannot make use of the tax shelter. The Treasury's report had a very brief sentence that I think is worth reading to you, referring to the exemption from capital gains pre-FIRPTA.

It said, "Exemption from capital gains taxation may be seen as an offset, roughly, for the prior denial of deductions. . . ."

In other words, it's about tit for tat, if you will. If a foreign investor is exempt from capital gains tax on his investment in U.S. real estate, he's put on about the same basis according to the Treasury, as a U.S. investor who can make use of tax shelter. The agricultural investments are another story, and I don't think they are a problem, myself.

I think it is very desirable, going further, for the Congress to seriously consider the cost-benefit aspects of FIRPTA. I won't try to go into detail or make projected cost, actual hard cost, suggestions as to what it will cost by the time the Treasury has put out we don't know how many more conflicting and inconsistent tax regulations or how much it will cost the Government to renegotiate all the existing tax treaties, as a matter of out of pocket costs. What I would suggest to you this morning is that the diplomatic costs involved with FIRPTA are enormous and will be long range in their effect on the Government.

FIRPTA has the effect—and an unprecedented effect I think it is—of overriding unilaterally, selectively, specific provisions of a large number of tax treaties which this country negotiated with its treaty partners in apparent good faith. Many of our treaty partners are terribly concerned about this unprecedented, unilateral selective override of treaty provisions. What they think is that if we are dissatisfied with our treaties, we should terminate those treaties in their entireties or, more appropriately and more in line with policy, renegotiate the entirety of the treaties. Many of our treaty partners think that it makes a mockery of the process of negotiating tax treaties with this country if we get in the position of selectively overriding specific provisions.

Finally, in the materials submitted to you this morning, as well as in the 1979 report, it is suggested that somehow the exemption that the pre-FIRPTA foreign investor enjoyed from capital gains tax in certain instances, because he could structure his investment in a way to avoid capital gains tax upon his ultimate disposition of his real estate investment, was an anomaly, that somehow before FIRPTA we were being provincial in the United States, we were being dupes, we were not charging a tax that is being charged widely by other countries.

I suggest to you that the statement in the Treasury report and in this morning's report is substantially inaccurate. In the report itself, after analysis of some provisions—analysis, which in part, I think, is inaccurate—the Treasury concluded that "despite their frequently broader scope in attempting to tax nonresidents, meaning U.S. investors investing abroad, effective taxation of gain on the disposition of real property by nonresidents--meaning U.S. persons—is probably rarely realized." And it is probably rarely realized because these tax laws of foreign countries typically do not reach and tax U.S. investors when they make true nonbusiness real estate investments, meaning nonmanufacturing—related real estate investments, in foreign countries. With FIRPTA our law is much more stringent than many tax laws of other countries, such as the United Kingdom, such as The Netherlands, such as the law of Germany, to name three of our major trading partners.

Finally, if I may conclude, I would say that it is my strong belief that the policy of the United States should to be encourage foreign investment in U.S. real estate; not to discourage it as FIRPTA does. I believe that a foreign investor, by making a real estate investment here, a long-term, illiquid investment, has made common cause with our Government's future and the future of this country, and that should be encouraged, not discouraged.

Senator WALLOP. Thank you, Mr. Knight.

[The prepared statement and a letter from Mr. Knight follow:]

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STATEMENT OF W. DONALD KNIGHT, JR.
BEFORE
COMMITTEE ON FINANCE
UNITED STATES SENATE

June 19, 1984

REPEAL OF FIRPTA IS IN THE BEST ECONOMIC INTEREST OF THE UNITED STATES

Mr. Chairman, I appreciate very much Senator Goldwater's inviting me to appear before this Committee, and I appreciate the Committee's granting me the opportunity to speak today on the subject of whether the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") should be repealed.

As Senator Goldwater has indicated, I am a partner in the law firm of King & Spalding and practice in that firm's Atlanta office. My practice is basically devoted to representing foreign private and institutional clients with regard to their U.S. investments. The U.S. investments made by foreign clients of my firm include substantial investments in U.S. real estate of various kinds and also include other types of investments, ranging from private holdings of portfolios of U.S. stocks and bonds to institutional investments in U.S. venture capital funds to foreign corporate acquisitions of U.S. manufacturing companies.

Since the passage of FIRPTA, at least 70 articles concerning FIRPTA have appeared in tax and other professional journals. Virturally all of these articles discuss the multitude of technical problems inherent in FIRPTA. I do not intend to discuss these technical problems today. Rather, the point I hope to convey is more fundamental. I believe that FIRPTA is inconsistent with the basic pattern of U.S. taxation of foreign investment of all kinds other than real estate and that FIRPTA is thus an aberration. Further, I believe for a number of reasons that repeal of FIRPTA would be in the best economic interest of our country.

I.

THE INTERNAL REVENUE CODE PROVISIONS OTHER THAN FIRPTA HAVE THE EFFECT OF ENCOURAGING FOREIGN INVESTMENT IN THE UNITED STATES; FIRPTA IS AN ABERRATION

As is the case today, 20 years ago the U.S. balance-of-payments situation was a cause for serious concern. On October 2, 1963, President Kennedy appointed a Task Force (the so-called "Fowler Task Force") to examine ways and means of promoting increased foreign investment in the United States. The Fowler Task Force submitted its report to President Johnson on April 27, 1964. Among its recommendations, the report stressed that revision of the U.S. approach to taxation of foreign investors* then in effect would be "one of the most immediate and productive ways to increase the flow of foreign capital to this country."[1]

A notable result of the Fowler Task Force report was the enactment of the Foreign Investors Tax Act of 1966 ("FITA"). One of the stated objectives of FITA was "providing . . . increased incentives for investments by . . . [nonresident aliens and foreign corporations] in the United States."[2] Since they became effective, the provisions which FITA added to the Internal Revenue Code (the "Code") have generally governed taxation of foreign investment in the United States. A number of the FITA provisions of the Code clearly were designed to encourage foreign investment. For example, stated generally and disregarding the effects of FIRPTA:

(a) Foreign investors are not required to pay any U.S. capital gains tax on profits they realize from investing in U.S. stocks and bonds.[3]

(b) A foreign investor can organize a U.S. corporation, have that U.S. corporation conduct active U.S. industrial and commercial activities for years, then sell the shares of the U.S. corporation free of any U.S. capital gains tax.[4]

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* For purposes of this statement, the term "foreign investor" will be used to refer to nonresident alien individuals and corporations not organized in the United States unless an express distinction is made between those types of foreign investors.

(c) Foreign investors are not required to pay U.S. income tax on interest they receive from U.S. bank accounts, savings and loan accounts and certain accounts left at interest with U.S. life insurance companies.[5]

(d) Foreign investors are not taxed on the interest they effectively receive as original issue discount from Treasury bills, U.S. commercial paper, or the like, provided these investments have an original maturity of not more than 6 months.[6]

(e) The estates of foreign investors are not required to pay U.S. estate tax on deposits held in U.S. bank accounts, savings and loan accounts, etc., at the time of death of such investors.[7]

(f) The estates of foreign investors are not required to pay U.S. estate tax on U.S. life insurance proceeds.[8]

Prior to the enactment of FIRPTA, a foreign investor was subject to tax on the sale of his or its U.S. real property investments in accordance with the general FITA rule that foreign investors are not subject to tax on any U.S. source gains unless the foreign investor is engaged in a U.S. trade or business and the real estate gain is effectively connected with that U.S. trade or business. Many foreign investors held U.S. real property through corporations organized in the United States or elsewhere that either (a) were engaged in a U.S. trade or business as to their real estate holdings (in many cases because under U.S. tax cases a very low level of mere stewardship activity as to real estate holdings has been held to place a foreign investor in a U.S. trade or business) or (b) had made a special Code or tax treaty election to be taxed on their real estate rental income as though such corporations were engaged in a U.S. trade or business. When they wished to sell their U.S. real property held in this manner, many foreign investors simply sold the shares of stock of their real estate holding company or took similar tax planning steps to divorce the gain generated by the sale from the (real or elected) U.S. trade or business of the holding company.

The Treasury Department's May 1979 Report to Congress on "Taxation of Foreign Investment in U.S. Real Estate" (the "Treasury Report"), stated that the "abuse highlighted in this Report is . . ." that foreign investors are able to convert "capital gains on real estate which had been used in a U.S. trade or business . . . into capital gains on the sale of [corporate] shares."[9] As noted above, this perceived "abuse" resulted because a foreign investor making a pre-FIRPTA sale of the shares of a real estate holding corporation generally was not subject to U.S. tax on the gain from the sale of such shares.

Given that both before and after FIRPTA it is clear that a foreign investor who owns all of the shares of a U.S. manufacturing subsidiary can sell those shares free of U.S. tax--notwithstanding the fact that the U.S. corporation has been engaged in an active business in the United States--it is extremely difficult to see how a foreign investor's pre-FIRPTA ability to sell shares of a real estate holding company free of U.S. tax represented an abuse. Moreover, it is difficult to understand why such tax planning by foreign investors holding U.S. real property was seen as objectionable or artificial when the provisions of the Code dealing with foreign investment in U.S. stocks and other securities and the Regulations issued under those provisions blueprint specific and highly artificial "safe harbor" legal structures which a foreign investor may adopt (as to the location of the investor's "principal office," and otherwise) in order to (a) avoid any possibility that the investor will be treated as engaged in a U.S. trade or business as to the investor's U.S. securities trading activity and, thus, (b) avoid any possibility of U.S. tax on gains from such investments.

Nevertheless, FIRPTA attempts to deal with this "abuse," and the FIRPTA tax on foreign investment in U.S. real property is virtually the only instance in the Code where tax is imposed on gain realized from foreign investment in the United States without regard to whether the foreign investor is engaged in a U.S. trade or business or whether the gain is effectively connected to such a trade or business. Indeed, without regard to the facts, FIRPTA automatically deems each foreign investor who makes a disposition of U.S. real property (or the shares of a U.S. real property holding corporation) to be engaged in a U.S. trade or business and automatically treats the realized gain as being effectively connected with that "deemed" trade or business. In the case of every kind of U.S. investment other than real estate, a foreign investor normally can avoid paying any U.S. tax on capital gains resulting from his U.S. investment by the simple expedient of holding that investment through a U.S. or other corporation and selling the shares of that corporation when the investor wishes to dispose of his or its investment. Even though the Treasury Report noted that "taxing . . . capital gain on the sale of shares in a corporation owning U.S. real estate would . . . be a **departure from international norms**,"[18] FIRPTA subjects foreign investors to a tax when they dispose of shares of a U.S. corporation if such investors fail to prove that the bulk of the corporation's holdings are not composed of U.S. real property.

The conclusion is unavoidable. There are many provisions in the Code designed to encourage foreign investment in the United States. Under these provisions, foreign investors rarely are subject to tax on gain realized from the disposition of any kind of non-real estate investment in the United States. However, completely at variance with the general pattern of U.S. taxation of foreign investors, FIRPTA goes to great lengths, indeed, beyond "international norms," to tax foreign investors on gains directly or indirectly realized from investment in U.S. real estate. In the context of the overall U.S. regime for the taxation of foreign investment, FIRPTA is plainly an aberration.

II.

THE "TAX EQUITY" RATIONALE FOR FIRPTA IS FALLACIOUS; FIRPTA DOES NOT RESULT IN FOREIGN INVESTORS BEING TREATED "THE SAME AS U.S. PERSONS"

As described above, the FIRPTA tax on gains realized by foreign investors from the sale or other disposition of interests in U.S. real property is generally inconsistent with the pattern of U.S. taxation of gains realized by foreign investors from all other types of U.S. investments. Moreover, in the words of the Treasury Department, by taxing gain realized by foreign investors from the sale of shares of a corporation which owns U.S. real property, the FIRPTA tax represents "a departure from international norms."[11] Further, the rationale that FIRPTA "treat(s) foreign investors the same as U.S. persons"[12] is completely fallacious.

Responding to publicly-expressed, emotionally-charged concerns that foreign investors were purchasing an inordinate amount of U.S. farmland, driving up the price of such property and undermining the "family farm,"[13] Senator Malcolm Wallop of Wyoming introduced legislation in 1978 aimed solely at taxing foreign investors on gains realized from their sales or other dispositions of U.S. **agricultural** property. At a hearing of a subcommittee of this Committee held almost exactly five years ago on June 25, 1979, the Treasury Department argued strongly that Senator Wallop's bill should be expanded to apply equally to all U.S. real estate. That approach was ultimately adopted, and the final result was FIRPTA. The legislative history of FIRPTA indicates that the basic purpose for the adoption of FIRPTA was "to establish equity of tax treatment in U.S. real property between foreign and domestic investors."[14].

On the surface, the idea of treating foreign investors equally with U.S. investors with respect to gains realized from U.S. real property sounds attractive and reasonable. However, viewing FIRPTA in the context of the overall pattern of U.S. taxation of foreign investment, the FIRPTA tax on U.S. real property is virtually the only instance where the United States taxes a foreign investor on gains whether or not those gains are connected with a U.S. trade or business. Furthermore, as described above, there are numerous provisions in the Code where, in an effort to encourage foreign investment, foreign investors are granted complete exemption from U.S. taxation which would apply to a similarly situated U.S. taxpayer.

Moreover, the entire U.S. system of taxing foreign investors fundamentally differs from the tax rules which apply to U.S. persons. Very generally, a U.S. person is subject to U.S. income tax on all of his or its income derived from anywhere in the world. A U.S. person's tax liability is determined by

(a) totaling the entire amount of his or its worldwide income of all types,

(b) subtracting certain deductions to produce the amount of net taxable income of the U.S. person,

(c) applying the applicable tax rate schedule to the net taxable income of the U.S. person to arrive at his or its basic tax liability, then

(d) subtracting any available tax credit items to arrive at the ultimate tax due from the U.S. person in question.

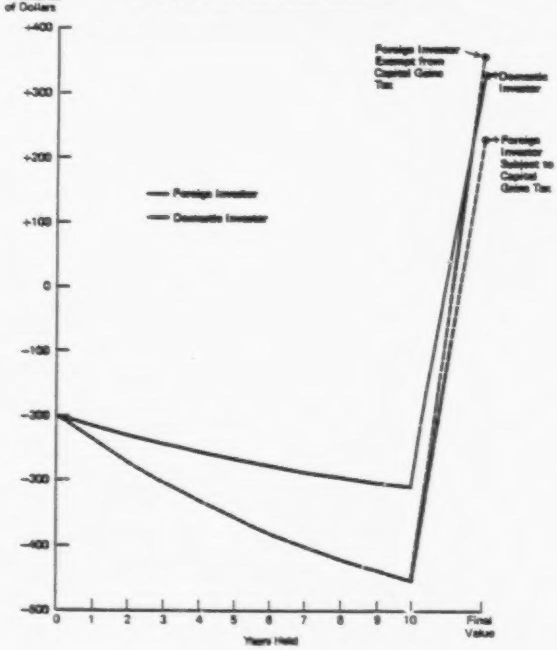
By contrast to this tax regimen applicable to a U.S. person under which all income of every kind of a U.S. person is added together as a first step in the process, the Code divides a foreign investor's U.S. source income into two distinct categories, (i) income effectively connected with a U.S. trade or business of the investor and (ii) income which is not effectively connected with such a U.S. trade or business. The first category, "effectively connected" income, is generally subject to U.S. tax at the graduated rates which would apply to a U.S. person, after allowing for deductions from that income similar to those available to a U.S. person. However, the second category of U.S. source income realized by a foreign investor (that is, income which is not effectively connected with a U.S. trade or business) is taxed under the Code pursuant to an entirely separate and different system. In calculating the U.S. tax applicable to this type of income (which generally includes passive income such as dividends, interest, royalties, etc.), a foreign investor is allowed no deductions whatsoever. Rather, the gross amount of such income is subject to U.S. tax at the rate of 30% (or any more favorable rate prescribed by an applicable tax treaty).

Under the Code, it is absolutely clear that U.S. persons and foreign investors are subject to completely different methods of U.S. taxation on their income, and, in addition, the Code contains a number of special provisions aimed at encouraging foreign investment in certain specific types of U.S. properties. Therefore, given these widely differing patterns of U.S. taxation which apply to U.S. persons, on the one hand, and foreign investors, on the other, any argument is doomed to failure which proceeds from the premise that foreign investors should be treated "the same as U.S. persons." The only way to achieve such a result is to amend from stem to stern the provisions of the Code applicable to foreign investors.

However, putting on blinders and focusing solely on the taxation of foreign investment in U.S. real property in effect after the adoption of FIRPTA, as compared with the taxation of investment in real property by U.S. persons, it is clear that the result of FIRPTA is **not** to tax foreign investors the same as U.S. persons with regard to their U.S. real property investments. Indeed, in the Treasury Report of May 1979, the Treasury Department itself pointed out that applying capital gains taxation to profits realized by a foreign investor from U.S. real property would in many cases place a foreign investor at a disadvantage when compared to his or its U.S. counterpart.

The Treasury Report analyzed a hypothetical investment in U.S. farmland and set out the following graph (copied from the Report):

Figure 1: Present Value of Accumulated Cash Flow from a Hypothetical Investment in U.S. Farmland to a Foreign vs. Domestic Investor



This graph prepared by the Treasury Department establishes that the overall, after-tax benefit to a foreign investor in the hypothetical U.S. farm is nearly equal to the after-tax benefit to a U.S. investor, even when the foreign investor pays no U.S.

capital gains tax! The reason the pre-FIRPTA, capital gains-exempt foreign investor has an economic benefit from the farm investment only slightly different from the benefit reaped by the U.S. investor who is subject to capital gains tax is that the hypothetical farm investment described in the Treasury Report "is assumed . . . to provide a tax shelter for a domestic investor, but to have no such shelter value for a foreign investor."[15] Further, the Treasury Report and the graph of the hypothetical investment in U.S. farmland reflect that the foreign investor will "bear a heavier burden if his capital gain . . . [is] subject to [FIRPTA] tax."[16]

The example charted in the Treasury Report involves an investment in non-depreciable farmland. The situation is even more extreme where developed real estate is involved. Assume a U.S. individual is in the 50% tax bracket and has a large amount of dividend income. Assume further that the U.S. individual invests in an office building which produces "paper" tax losses of $100,000 per year to the U.S. investor. The U.S. investor can use the $100,000 per year of "tax shelter" resulting from his real estate investment to offset $100,000 per year of dividend income. During the time he holds the property, he would have $50,000 per year of tax savings and would retain full use of the annually-saved $50,000. When the U.S. investor sells the property (assuming depreciation on a straight-line basis), the investor will only pay tax on gain realized above the depreciated basis of the building at a maximum rate of 20%--in spite of the fact that he has claimed tax shelter deductions resulting from depreciation of the property against dividend income which would have been taxable to him at the rate of 50%, absent the "tax shelter" provided by the building. By contrast, because of the entirely different pattern of U.S. taxation applicable to a foreign investor, a foreign investor cannot use "tax shelter" from a U.S. real estate investment "to offset U.S.-source interest, dividends, and other income not effectively connected with a U.S. trade or business."[17]

Capital gains taxes are only one of a number of investment considerations in a real estate transaction. There are other important factors such as interest deductions, depreciation, write-offs, etc. These latter considerations are critical, if not determinative, for U.S. investors who receive U.S. tax shelter advantages not available to foreign investors. Unlike a U.S. investor, a foreign investor generally cannot benefit from a tax shelter generated by a U.S. real estate investment. In order to make a realistic comparison between the after tax results of real estate investment to a foreign investor, as compared to a U.S. investor, one cannot simplistically assume that a foreign investor's not being subject to U.S. capital gains tax automatically means that the foreign investor has an economic advantage compared to his U.S. counterpart. As stated in the Treasury Report, because a foreign investor often cannot benefit from tax shelter generated by a U.S. real estate investment, the pre-FIRPTA "exemption from capital gains taxation may be seen as a offset, roughly, for the prior denial [to the foreign investor] of [tax shelter] deductions . . . [from U.S. real estate investment]."[18]

In my experience, foreign investors, much more than U.S. investors, hold real estate for the long-term. The benefit of the pre-FIRPTA effective exemption from U.S. capital gains tax for gain realized by a foreign investor from his or its U.S. real property investments is a benefit which was realized only infrequently by the foreign investors we represent. However, as plainly reflected in the Treasury Department's own analysis, the imposition of the FIRPTA capital gains tax can result in foreign investors bearing a heavier burden of taxation than their U.S. counterparts. FIRPTA cannot be justified by the contention that the Act results in foreign investors being taxed on real estate investments the same as U.S. persons; the "tax equity" argument in support of FIRPTA is illusory and without foundation.

III.

THE MINOR TAX REVENUE INCREASE PROJECTED TO RESULT FROM FIRPTA WILL BE FAR EXCEEDED BY THE REAL COSTS OF ATTEMPTING TO ADMINISTER FIRPTA AND THE INTANGIBLE "DIPLOMATIC COSTS" TO THE UNITED STATES RESULTING FROM FIRPTA'S UNILATERAL, SELECTIVE OVERRIDING OF PROVISIONS IN NUMEROUS TAX TREATIES

When FIRPTA was enacted, the revenue gain resulting from the Act was projected to be $42 million in fiscal year 1981, $92 million in fiscal year 1982, $102 million in fiscal year 1983, $111 million in fiscal year 1984 and $123 million in fiscal year 1985. The revenue gain was then expected to increase to about $200 million annually, because, effective generally on January 1, 1985, FIRPTA unilaterally overrides certain provisions in numerous existing tax treaties to which the United States is a party that otherwise would prevent the application of the FIRPTA tax in certain circumstances. The Treasury Department has repeatedly acknowledged that these revenue gain estimates "may be subject to substantial error."[19] The Treasury has also conceded that its revenue estimates do not take into consideration the extent to which FIRPTA will result in reduced foreign investment in U.S. real property.[20]

It is submitted that the revenue projected to be produced by FIRPTA--a pittance in terms of the budget of the U.S. government--will be far exceeded by the real and intangible costs of FIRPTA. As to real costs, the U.S. government (notably the Treasury Department) has already spent an enormous amount of valuable time attempting to produce regulations under FIRPTA which will provide even a modicum of guidance to foreign investors and their advisors. Thus far, a partial set of temporary and proposed regulations were issued in September of 1982, and additional proposed regulations (covering in a different way a part of the subject matter already addressed in the 1982 regulations) were issued in November of 1983. At this point in time no one can predict with certainty when final Regulations under FIRPTA will be issued--even final Regulations limited to the subject areas covered by the November 1983 proposed regulations. Nearly four full years after the effective date of FIRPTA, no regulations of any kind have yet been issued under many of the complex provisions of FIRPTA.

Beyond the cost of preparing regulations to guide a foreign investor through the maze of FIRPTA, the U.S. government will be faced with the actual expense of renegotiating numerous tax treaties which contain provisions that will be overriden unilaterally by FIRPTA on January 1, 1985. Thus far, since the enactment of FIRPTA, only the treaty with Canada has been renegotiated in light of FIRPTA, and that treaty is not yet in effect. (Further, assuming the treaty with Canada becomes effective in its present form, FIRPTA will not apply to Canadian investments in U.S. real property until a year after the treaty's effective date, and Canadian investors will effectively be given a step-up in the tax basis of the U.S. real estate they held on September 26, 1980, to the fair market value of the property as of that date. Given that Canada is one of the major sources of foreign investment in U.S. real estate, these new treaty provisions likely will substantially reduce tax revenues from FIRPTA.)

The cost of printing and maintaining the specialized tax returns, reports, and the like required by FIRPTA will itself be significant. Moreover, given that highly specialized tax advisors in the United States are at a loss as to how to advise foreign investors in many areas covered by FIRPTA, it may be assumed that the enforcement of FIRPTA will require the Internal Revenue Service to hire and specially train additional revenue agents, all at further costs.

In my own experience, I have seen foreign investors, because of FIRPTA, choose to invest in U.S. portfolio assets (where generally no U.S. capital gains tax is applicable), rather than investing in U.S. real property. Because of FIRPTA other foreign investors my firm represents simply have chosen not to invest in U.S. assets at all, at least for the time-being. FIRPTA's discouragement of foreign investment in U.S. real estate has undoubtably caused the U.S. government to lose taxes which otherwise would have been paid by construction workers, contractors, and the like, who would have been employed in development projects financed by foreign funds--not to mention the loss of additional U.S. jobs which such investment could have created. Tax revenue which would have resulted to the United States on fees paid by foreign investors to U.S. real estate advisors, tax professionals, lawyers, and the like, has also been lost because of FIRPTA.

In short, the real costs associated with FIRPTA may substantially--if not entirely--offset the pittance of tax revenue which FIRPTA is projected to generate. More importantly, the discouragement of foreign investment resulting from FIRPTA is at variance with President Reagan's recent statement on the International Investment Policy of the United States (made September 9, 1983), where it is stated that the "United States welcomes foreign direct investment," believes that "such investment provides substantial benefits to the United States" and, therefore, wishes to foster a "climate which is conducive to [foreign] investment."

Moreover, the intangible costs to the United States resulting from FIRPTA will be enormous. As noted, under the terms of FIRPTA, the United States will selectively override specific tax treaty provisions with a large number of other countries, effective January 1, 1985. The Treasury Department has noted that:

> The process of negotiating and ratifying a tax treaty is long and arduous. The process would be rendered all the more difficult, if not altogether impossible, if the United States were to begin overriding specific treaty provisions a foreign country had negotiated in good faith.[21]

For these reasons, the Treasury Department advocated, and FIRPTA adopted, the approach of not effecting an immediate FIRPTA override of treaty obligations, but of postponing the treaty override generally until 1985, in order to "allow the Treasury sufficient time to implement appropriate modifications in . . . treaties before statutory changes [effected by FIRPTA become] . . . effective."[22]

Notwithstanding the Treasury's optimistic projection that it would be able to renegotiate all conflicting tax treaties before the FIRPTA override in 1985, at this point in time, approximately six months before FIRPTA will unilaterally override selective provisions of many tax treaties which were negotiated in good faith by our treaty partners, only one lonely tax treaty has been renegotiated to take into account the provisions of FIRPTA. As noted, that treaty (with Canada) has not yet become effective.

Tax treaties are highly negotiated agreements in which the respective countries involved attempt to obtain benefits for their nationals and residents. A fundamental assumption which underlies a tax treaty is that each country involved has accepted the provisions of the treaty and will abide by them until and unless they are renegotiated. The FIRPTA provisions specifically overriding conflicting provisions in existing U.S. tax treaties have been the cause of serious concern among our treaty partners. Many of the countries with which we have treaties think that FIRPTA's unilateral, selective override of existing tax treaty provisions makes a mockery of the process of negotiating tax treaties with the United States and nullifies the purpose of concluding such treaties with our government. The "diplomatic cost" to the United States if FIRPTA is not repealed and is allowed to override tax treaty provisions which were negotiated in good faith will be extraordinarily high, far greater than the pittance of tax revenue which FIRPTA is projected to produce.

IV.

THE POLICY OF THE UNITED STATES SHOULD BE TO ENCOURAGE FOREIGN INVESTMENT IN U.S. REAL ESTATE IN ORDER TO GIVE FOREIGN INVESTORS A LONG-TER STAKE IN THE WELL-BEING OF OUR COUNTRY

Existing U.S. tax law has the effect of encouraging foreign investment in U.S. portfolio assets such as U.S. stocks and bonds and certain money market instruments. Further, the Administration is strongly supporting additional tax relief for portfolio investments in the form of repeal of the existing withholding tax on U.S. source portfolio interest paid to foreign investors. On May 1, 1984, Ronald A. Pearlman, Deputy Assistant Secretary of the Treasury (Tax Policy) told the House Ways and Means Committee that the Administration prefers an immediate and complete repeal of the withholding tax on such interest and that the Administration believes that a repeal of the withholding tax in question would have economic benefits to the United States in the form of increased capital formation and sustained economic growth. For these economic policy reasons, Mr. Pearlman stated his desire "to emphasize" that the Administration's support of repeal of the withholding tax on portfolio interest "has never depended on whether there was a revenue gain or loss."

As discussed earlier, I believe that the real, net revenue gain to the U.S. government resulting from FIRPTA will be slight--if such a gain exists at all. However, regardless of the tax revenue effects of FIRPTA, FIRPTA should be repealed as a matter of economic policy of the United States.

There are sound reasons for encouraging foreign investors to make portfolio investments in the United States. However, because of the highly liquid nature of such investments, portfolio investments in publicly-traded shares, in bearer bonds, in money market instruments, or the like, do not result in any commitment by a foreign investor to his U.S. investment. When a foreign investor has doubts about the U.S. economy or about the particular liquid investment he has made, the investor is easily in a position to "vote with his feet," convert his assets into cash and even transfer his funds out of the United States entirely. Recently, widely-publicized stories have indicated that substantial withdrawals of funds by frightened foreign investors substantially accelerated the difficulties of Continental Illinois Bank. The lesson is clear.

By contrast, virtually without exception real estate investments are illiquid, long-term commitments of capital. When a foreign investor makes an investment in U.S. real property, that investor has a true, long-term stake in the well-being of the United States. With such an investment, the foreign investor makes common cause with our country and its future.

The policy of the United States should be to encourage foreign investment in U.S. real property. FIRPTA should be repealed for this reason.

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June 29, 1984

The Honorable Malcolm Wallop
United States Senate
Room 206
Richard B. Russell Senate Office Building
Washington, D.C. 20510

Re: Proposed Repeal of FIRPTA--S.1915

Dear Senator Wallop:

Last Tuesday, June 19, at the invitation of Senator Goldwater I testified before the Senate Committee on Finance in favor of Senator Goldwater's proposal in S.1915 that the Foreign Investment in Real Property Tax Act ("FIRPTA") be repealed. I appreciated the Committee's allowing me to testify, and I particularly appreciated the gracious manner in which you chaired the hearing.

The purpose of this letter is to confirm in writing several points which were raised during the course of the hearing, as follows:

1. FIRPTA Applies to Investments by Foreign Investors in U.S. Oil and Gas Interests.

Lord Mark Fitzalan Howard, appearing on behalf of the Association of Investment Trust Companies of the United Kingdom, stated at the hearing that FIRPTA has the effect of discouraging foreign investment in U.S. oil and gas properties at a time when the policy of our government should be to encourage such investment, given the difficulties in the area of the Persian Gulf. You questioned whether, in fact, FIRPTA covers such U.S. properties as oil and gas leases, and the like. You stated that it would be an "astonishing distortion" if FIRPTA covered such properties.

This will confirm the response I made during the hearing: FIRPTA clearly includes in its definition of U.S.

real property "an interest in a mine, well, or other natural deposit." I.R.C. §897(c)(1)(A)(i). Under both the temporary and proposed FIRPTA regulations which have thus far been issued, an interest in real property is said also to include "any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by ... real property." Temp. Regs. §6a.897-1(d)(3); Prop. Regs. §1.897-1(d)(2). Therefore, it appears absolutely clear that any equity interest a foreign investor holds in U.S. oil and gas properties would be subject to FIRPTA, including interests which may be characterized as oil and gas "leases."

Further, you may be interested to know that, under the proposed FIRPTA regulations issued in November of 1983, if a foreign investor owns U.S. real property which has on it oil derricks, oil and gas pipelines, oil storage tanks or other equipment used to extract oil and gas from the ground, those improvements to the foreign investor's U.S. real property would also constitute U.S. real property subject to the FIRPTA tax.

[Demonstrating further the continuing uncertainty and confusion which FIRPTA has caused in the oil and gas area and elsewhere, there is a clear-cut conflict between the two sets of FIRPTA regulations on the subject of whether mineral "production payments" described in I.R.C. §636 are "real property" for FIRPTA purposes. Compare Temp. Regs. §6a.897-1(d)(3) with Prop. Regs. §1.897(d)(2).]

2. FIRPTA Has Substantially Reduced the Amount of Foreign Investment in U.S. Real Estate, Oil and Gas Exploration and High Technology, "Venture Capital" Companies.

During the course of the hearing, you indicated that, "in this time of budget deficits," the case for repeal of FIRPTA would be strengthened significantly if it can be demonstrated that FIRPTA is costing the U.S. government revenue because of "the disincentive to investment created" by FIRPTA. I believe it can be shown that FIRPTA is a very significant deterrent to foreign investment in U.S. real estate, in U.S. oil and gas properties and privately-held oil and gas exploration companies and in privately-held companies doing business in high technology and other areas typically attractive to venture capital investors. I believe the FIRPTA-caused disincentive for foreigners to invest in such assets has cost the U.S. government substantial tax revenues (which would have been paid by U.S. persons who typically would have sold such properties to foreign investors) and has resulted in the U.S. economy's losing the benefit of substantial infusions of foreign capital.

At the time of its May 1979 Report to the Congress on "Taxation of Foreign Investment in U.S. Real Estate" (hereafter called the "Treasury Report"), the Treasury Department stated that "like all revenue estimates" it makes, the Treasury's estimates of the revenue which would be produced by a FIRPTA-type capital gains tax "take no account of behavioral adjustments" which may follow from the imposition of the tax. More specifically, the Treasury stated that: "The extent to which ... [foreign investors'] aggregate investment in the United States would be reduced if capital gains were subject to U.S. tax is virtually impossible to predict." [Treasury Report, p. 54] Even with the benefit of hindsight, it is not possible to quantify exactly the amount of foreign investment which has been deterred by the enactment of FIRPTA.

Nonetheless, the conclusion is unavoidable that very substantial amounts of foreign investment have effectively been prevented by FIRPTA. In his written statement presented to the Finance Committee, Senator Goldwater stated that he is "convinced that FIRPTA is blocking hundreds of millions of dollars of investment money that is needed in this country." Senator Goldwater went on to note that, according to the U.S. Department of Commerce, "non-bank foreign land holdings increased by 4.8 million acres in 1981, but in 1982 new investment fell to 1.6 million acres and in 1983 it dropped all the way down to 360,000 acres." Senator Goldwater also noted that, according to other statistics from the Department of Commerce, "new foreign direct investment fell $16.2 billion from 1981 to 1983." At the same time, the Senator noted that the amount of foreign portfolio investment--which is generally not subject to a U.S. capital gains tax--had risen significantly in 1983, as compared to 1981. From this, Senator Goldwater concluded that:

> "The stronger dollar and lingering recession abroad cannot be used as the excuse for falling new foreign investment in real estate when foreign [portfolio] stock purchases have climbed more than a billion dollars in the same period."

Speaking for the multi-billion dollar pension funds making up the European Federation for Retirement Provison, Senator van Tets of The Netherlands indicated in his prepared statement to the Finance Committee that FIRPTA

> "has, without any doubt, seriously dampened our investment interest in U.S. commercial real estate, oil and gas exploration and high technology, and will continue to deter such investment unless this law is repealed or very substantially modified ...."

Similarly, Lord Mark Fitzalan Howard, representing the Association of Investment Trust Companies of the United Kingdom, whose members' assets approximate 19 billion pounds sterling, referred to FIRPTA as a "barrier" to investment in the U.S. which may cause U.S. enterprises to "be deprived of valuable [foreign] capital ...." Lord Howard went on to submit on behalf of his Association that

> "unless the effects of FIRPTA are removed, the result will be materially to reduce the finance from outside the U.S. for oil and gas exploration .... [because, with the FIRPTA tax applicable,]

> our investments in [U.S.] oil and gas companies will have to perform significantly better than those in any other country in order to compensate for the tax imposed by FIRPTA ...."

He further stated that "FIRPTA similarly jeopardizes our investment in high technology and other venture capital companies in the U.S." and indicated that, "because of FIRPTA, ... [U.K. investment trust companies] may increasingly turn away from investing in technology in the U.S. and focus on other areas such as Japan."

Lord Howard gave a specific example of a U.K. investment trust company which is a member of his association that "as a matter of policy now normally refuses opportunities to invest in any ... [U.S. high technology] company," [because such a company] "may be treated as a U.S. real property holding company" and "caught within the FIRPTA net."

While it is not possible to give precise statistics, I believe it is clear from this testimony that FIRPTA has substantially deterred desirable foreign direct investment in the United States, contrary to the best interests of our country.

3. Enactment of FIRPTA Withholding and Repeal of the FIRPTA Disclosure Rules Will Not Solve the Problem.

As shown, Senator van Tets and Lord Howard both testified that FIRPTA has the effect of significantly discouraging foreign investment in privately-held U.S. oil and gas companies and in U.S. companies that are involved in high technology and other businesses which are interesting for venture capital investors. It was noted during the hearing that replacing the present onerous investor disclosure rules of FIRPTA with provisions for enforcing the FIRPTA tax by withholding (since passed by Congress) will not solve the problem.

Even if FIRPTA is enforced by withholding, it will still generally be necessary for every foreign investor who holds shares in a privately-owned U.S. corporation and sells those shares to prove to the IRS that the U.S. corporation was not a "United States real property holding corporation" within the meaning of FIRPTA at the time the foreign investor sold his or its shares--or at any time during the past five years. If the foreign investor fails to establish that the U.S. corporation whose shares the investor sold was not a "United States real property holding corporation," the foreign investor generally will be subject to the FIRPTA tax.

Under both sets of FIRPTA regulations which have thus far been issued, the valuation and other procedures for establishing that a U.S. corporation was not a "United States real property holding corporation" as of a particular date are enormously detailed and problematical. As Lord Howard commented in his written statement:

> "What is the precise value of a partially proven oil or gas reserve and what is the value of a high technology company's patent rights and R&D know-how? Yet these valuations are critical in determining whether or not the company is within the scope of FIRPTA."

The enactment of a provision for enforcing the FIRPTA tax through a withholding mechanism does not ameliorate or relieve in any way these FIRPTA-caused uncertainties, and they remain onerous burdens on foreign investors. Yet the extraordinarily difficult FIRPTA procedures for determining whether a particular company is a "United States real property holding corporation" go to the very heart of the issue of whether the FIRPTA tax applies, not merely to procedural matters of disclosure or enforcement of the tax.

4. FIRPTA's Unilateral Overriding of Selected Provisions of U.S. Tax Treaty Obligations Is Without Precedent and Cannot Be Justified.

During the hearing I indicated my strong belief that FIRPTA should be repealed before January 1, 1985; otherwise, FIRPTA will have the unprecedented effect of unilaterally overriding selected provisions in a large number of U.S. tax treaties which our treaty partners believed the United States negotiated in good faith. The result will be to make a mockery out of the process of negotiating a tax treaty with our government. In a June 25, 1979, presentation to the Senate Finance Committee's Subcommittee on Taxation and Debt Management, the Treasury Department noted that:

> "The process of negotiating and ratifying a tax treaty is long and arduous. The process would be rendered all the more difficult, if not altogether impossible, if the United States were to begin overriding specific treaty provisions a foreign country had negotiated in good faith."

For these reasons, the Treasury advocated, and FIRPTA adopted, the approach of not effecting an immediate FIRPTA override of treaty obligations, but of postponing the treaty override generally until 1985, in order allegedly to allow the Treasury sufficient time to renegotiate the tax treaty provisions which otherwise would be overriden by FIRPTA. At the same June 1979 hearing the Treasury acknowledged that FIRPTA will override selected provisions in "about half of our treaties, about 15 treaties--and ... [that some of] the most important ... [treaties] would be involved." Yet at this point in time only our treaty with Canada has been renegotiated to take into account the provisions of FIRPTA, and the Canada treaty, itself, has not yet become effective.

If FIRPTA is allowed to stand and the United States thus unilaterally overrides selected provisions in numerous tax treaties to which this country pledged itself, the resulting diplomatic costs to the United States will be enormous. In the words of Senator van Tets, pension funds who are members of the European Federation for Retirement Provision were no less than

> "stunned to learn that ... [FIRPTA] would presume to override existing treaties, which it would not even be possible to renegotiate by January 1, 1985 by most of the countries represented in our organization."

5. The FIRPTA Tax on Foreign Investors' Gain From U.S. Real Property Is Contrary to the Tax Policies and Practices of Many of Our Major Trading Partners With Regard to Taxing "Foreign" Investment in Real Estate in Their Own Countries.

One final point noted at the hearing is worth emphasizing. The 1979 Treasury Report (Appendix B) states that, with the exception of the United States (before FIRPTA) and the United Kingdom, "nearly all other industrial countries ... tax nonresidents on capital gains from the disposition of real property located in the country ...." and goes on to state that, before FIRPTA, the United States was "generous" in allowing foreign investors to structure their U.S. real property holdings in order to avoid the U.S. capital gains tax as it existed before FIRPTA. The Report also says that "the United States, along with the United Kingdom, is exceptional in not taxing nonresidents on gain from the disposition of real property ...."

The facts are at odds with the impression created by these statements of the Treasury. In addition to the United Kingdom, a number of major industrialized countries which are our treaty partners do not tax nonresidents of these countries on capital gains realized from a real estate investment in the countries in question, so long as the investment is not directly connected with a non-real estate business of the investor (e.g., a manufacturing plant). The Netherlands is a good example of this approach. Other countries, such as Germany, do not tax foreign (or local) investors on their gains from non-business real estate, provided the real estate is held for a sufficient period of time (the holding period in Germany being two years).

Indeed, once one reads past the Treasury Report's generalities, one finds the more specific and accurate statement that

> "despite ... [the] frequently broader scope of [foreign laws] in attempting to tax non-residents, effective taxation [by foreign countries] of gain ... [realized by non-residents of those countries] on the disposition of real property ... [located in such countries] is probably rarely realized [because of available holding period provisions, the potential of using holding company structures for real estate investments, and the like]." [Emphasis added.]

A tax law is what it does, not what it appears to say on its surface: This statement of the Treasury plainly makes the point that the position of foreign investors who invested in U.S. real estate before FIRPTA was no better than the position enjoyed by nonresident persons making real estate investments in most other industrialized nations.*

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*Canada is a notable exception and goes to great lengths to tax capital gains from foreign investment in that country. However, for its own policy reasons, Canada has long been leery of foreign direct investment; the Canadian Foreign Investment Review Act has deterred much foreign investment in that country. By contrast, the stated policy of the United States, reiterated by President Reagan in his statement on International Investment Policy on September 8, 1983, is to "welcome" foreign direct investment as "an important source of capital" and to foster "a domestic economic climate which is conducive to investment."

Clearly, before FIRPTA the United States was not being "generous" or a "dupe" compared to most other such nations. Equally clearly, the provisions of FIRPTA (particularly those which attempt to tax foreign investors on their gains from sales of shares of real property holding corporations) represent a "departure from international norms," to use the Treasury Department's words. (Treasury Report, p. 4.)

* * *

It is my hope that the Congress will reconsider, and repeal, FIRPTA. I believe such action is consistent with the economic policy of the United States (a policy clearly underlying the recent Congressional decision to repeal the U.S. withholding tax on portfolio interest paid to foreign investors) and in the best economic interests of our country.

Respectfully submitted,

Donald Knight

W. Donald Knight, Jr.

WDKJr/saw

cc: Members of the U.S. Senate Committee on Finance

Senator Wallop. Mr. Richards.

STATEMENT OF TIMOTHY RICHARDS, CORRIGAN ZELMAN & BANDER, MIAMI, FL

Mr. Richards. Mr. Chairman, members of the committee, I have been involved in thousands of transactions involving foreign investors and U.S. real estate. Based upon this experience, it is my considered opinion that FIRPTA discourages foreign investment in U.S. real estate. It is not so much the economic impact of the tax as it is the uncertainty and even panic generated by this legislation.

The amendment of FIRPTA to include withholding provisions will not remove much of this uncertainty and disincentive. Moreover, a withholding system simply is not realistic or feasible.

I would like to read into the record the House Ways and Means report prepared in connection with the revenue bill of 1936 wherein it was originally proposed to tax foreigners on their capital gains related to real estate.

The committee stated that:

> Such a nonresident will not be subject to tax on capital gains, including gains from hedging transactions, as at present it having been found impossible to effectually collect this latter tax. It is believed that this exemption from tax will result in additional revenue from the transfer taxes and from the income tax in the case of persons carrying on the brokerage business.

Foreign investment has been an important source of capital in this country for centuries. Currently, foreign investors maintain many real estate markets in this country and have created thousands of jobs for U.S. citizens. Economies such as south Florida, Dallas, Houston, Atlanta, and many more, have benefited tremendously from foreign investment in office buildings, shopping centers, apartment complexes, et cetera.

Foreigners invest here because of economic reasons and because of the stability of our law and the perception that the U.S. welcomes foreign investment. FIRPTA has sent a clear and convincing message to many of these foreign investors; namely, that the stability of U.S. laws is in question, and that U.S. lawmakers do not encourage foreign investment in U.S. real estate.

There is a proposal that would amend FIRPTA to include withholding requirements. These amendments should not be viewed as a panacea and cure-all for the ailing FIRPTA bill. Withholding may replace the reporting requirements which have caused so much furor, but a withholding system will not cure the internal inconsistencies, inequities, and uncertainties caused by FIRPTA.

I have been opposed to withholding since my first article on the subject appeared in the International Tax Journal in April 1980. I have carefully restudied this withholding proposal, including the suggestions submitted by the tax section of the Florida bar. I remain convinced that withholding will add substantially to the negative effect of FIRPTA.

The reasons for my position are as follows: First, many of the important withholding provisions require regulations. Is there any reason to believe that these regulations will be published before 1988?

In the meantime, uncertainty will surround many transactions involving foreigners and U.S. real estate.

Second, withholding creates unreasonable liabilities for U.S. citizens in many instances. For example, what happens in a transaction where no cash changes hands, such as a exchange or a mortgage foreclosure? A U.S. bank foreclosing on a mortgage may be required to remit 10 percent of the fair market value of the property to the Federal Government in order to satisfy its withholding liabilities. This is unreasonable.

Similar problems are exacerbated by a lack of regulations.

Third, it is unfair to the foreign investor to impose withholding because it deprives the foreign investor of his money prematurely. In contrast, a U.S. seller making a sale in 1984 may not be required to pay any tax until April 1985. Accordingly, I predict withholding will have a chilling effect on real estate transactions as foreign investors attempt to obtain higher prices for their property

Fourth, a fair withholding system is unworkable. For example, withholding provisions allow for fair adjustment of the withholding rate prior to sale. The IRS may be required to react to these requests within 15 days, and I submit that it will be impossible for the IRS to so react.

What happens if the IRS fails to react? Will it waive its taxing jurisdiction?

In conclusion, I believe that FIRPTA is robbing the United States of millions of dollars of foreign capital and jobs for U.S. citizens. I would urge you to repeal this law in its entirety.

Thank you.

[The prepared written statement of Mr. Richards follows:]

STATEMENT BY TIMOTHY RICHARDS
TO THE FINANCE COMMITTEE
UNITED STATES SENATE

TUESDAY, JUNE 19, 1984

My name is Timothy Richards and I am a member of the law firm of Corrigan Zelman & Bander, P.A. I am located in our Miami office, and approximately 90% of my practice involves assisting foreign investors making investments in the United States.

You have before you proposed legislation which would repeal the Foreign Investment in Real Property Tax Act (FIRPTA), a law which has had an overwhelmingly negative impact upon investors seeking to invest their funds in the United States. Foreign investment has played a key role in the development of the United States economy since the Revolutionary War. The Louisiana Purchase and the first transcontinental railway were projects which were financed with foreign capital. The enactment of FIRPTA, with its many internal inconsistencies and mechanical flaws, has and will continue to have a dampening effect upon this important capital source. I see several reasons for repealing FIRPTA in its entirety, which is why I appear before you today.

FIRPTA: CONTRIBUTING TO A DECLINE IN FOREIGN INVESTMENT

FIRPTA is directly contributing to a decline in foreign direct investment in the United States. The growth of direct investment in 1983 was decreased by $2.8 billion compared to 1982 statistics compiled by the Bureau of Economic Analysis of the Department of Commerce. In Florida, the decline of foreign investment in real estate has had a devastating impact on the local economy. Foreign investment in real estate declined 300% in 1982 in South Florida.[1] Part of this decline is due to the fact that foreigners are extremely sensitive to the investment atmosphere in any country. Americans investing abroad have traditionally weighed this factor very heavily, and foreigners investing here do the same. One of the reasons that the U.S. is favored by foreign investors is the stability of our laws; another is the perception that we welcome foreign investment. Unfortunately FIRPTA has negated both these reasons by creating many legal uncertainties which affect every foreign investor in U.S. real estate and by fostering the perception by many foreign investors that the United States is not interested in attracting foreign investment. An example of how a change in tax laws can alienate foreign investors is the enactment of the unitary tax in Florida. Many major foreign investors joined in a mass exodus from Florida when the bill was enacted. It was a clear signal to foreign investors that Florida was not receptive to the idea of encouraging foreign investment.

Another economic effect of FIRPTA is seen in the shift of foreign investment from direct active investment in real estate and related businesses to passive investments, as evidenced by recent BEA statistics, due to the fact that most of these indirect investments are still not subject to capital gains taxation under U.S. law. Direct investments, such as the construction and operation of office buildings,, create jobs and contribute to the economic health of a community. Indirect investments are generally less productive in creating jobs and contribute less to the health of local economies. In an era when our country needs more active direct investment, FIRPTA appears to be inconsistent with this need.

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[1] "The AREEA Report for South Florida", Volume 3, Issues 11, 12, pg. 2.

THE MYTH OF "PARITY"

Historically, foreigners were exempted from capital gains taxation because it was considered difficult, if not impossible, to enforce and collect this tax. When a foreigner is engaged in an active trade or business in the United States he is required to file a U.S. tax return. However, as is usually the case, if the investor himself is not engaged in a trade or business in the U.S. there is no effective mechanism to trace, monitor or report a realization of capital gains from the sale of a U.S. asset. Accordingly, foreigners are usually still not required to pay capital gains tax on the sale of U.S. stocks, bonds and other non-real estate capital assets post-FIRPTA. It is still not understood by most foreigners why only investment in U.S. real estate should be subject to capital gains taxation. The logical message to the foreign investor is that the U.S. is discouraging direct investment by foreigners in real estate.

The original FIRPTA proposal set forth by Senator Wallop was intended to discourage foreign investment in U.S. farmland due to the allegation that foreigners were better able to purchase U.S. farmland because of a perceived tax advantage. The focus of FIRPTA was then extended to all U.S. real property in the name of establishing "parity" between foreign and domestic investors in U.S. real estate. In reality, the "parity" principle is erroneous in that foreigners will generally pay larger capital gains taxes than their U.S. counterparts due to the fact that U.S. taxpayers usually have the option of sheltering their gains more feasibly than the foreign taxpayer. In addition, the filing of a U.S. tax return and other reporting forms may subject the foreign investor to unreasonable risks, including the threat of expropriation of his U.S. investments by his home country government. Once the IRS obtains the name and address of a foreign investor, it is probable that such investor will receive correspondence from the IRS. Notices of this type alert foreign government officials and other individuals to the activities of a foreign person abroad. In many countries kidnapping is an extremely real threat to foreign investors who have been identified in their home countries as being wealthy enough to invest abroad.

FIRPTA CREATES LEGAL AND FINANCIAL UNCERTAINTY

FIRPTA has created a great deal of legal uncertainty in the foreign investment community. For example, it was exceedingly difficult for many investors to receive timely notice of the enactment of FIRPTA or of filing dates for FIRPTA reporting forms. This problem created a near panic in our offices last March. Despite the fact that our office sent several notices to hundreds of our clients regarding a March 21 filing deadline, panic-striken investors arrived in Miami on March 20 requesting our assistance in the filing of information returns or security agreements in lieu of information returns. I am certain that dozens of our clients never received the notices and if the deadline had not subsequently been lifted by the Treasury these clients could have incurred sizable penalties. As it was, foreign investors spent thousands of dollars and many wasted hours attempting to comply with the FIRPTA law. I am certain that many of our clients who suffered through the frustrating process are wondering when it will happen again.

Let me emphasize the fact that our clients have a good deal of respect for U.S. law and have complied fully with all Federal and State regulations regarding foreign investment. Each of our clients has expended time and money to comply with the International Investment Survey Act (IISA), the Agricultural Foreign Investment Disclosure Act (AFIDA) and the reporting requirements under the Florida RICO Act. Although our foreign investors realized that IISA, AFIDA and the Florida RICO reports are applicable only to foreigners they have not complained of discriminatory treatment because the burden of compliance is not nearly as severe as the FIRPTA reporting requirements.

Compliance obligations of foreign investors have been complicated tremendously by the FIRPTA law. Our office maintains over 300 foreign corporations, each of which owns U.S. real estate. We will have to compile and maintain a current balance sheet for each year since 1980 for each entity in order to accurately prepare annual FIRPTA reports. In addition, hundreds of signatures must be obtained from clients scattered throughout the globe before the FIRPTA reports can be filed with the Treasury. Timely compliance with FIRPTA for all our clients will be extremely difficult.

Additional uncertainty is created by the fact that Final Regulations have not yet been issued. Since June of 1980 expert tax practicers have had a difficult time interpreting many of the nuances of the FIRPTA law without the benefit of regulations or other authority. Once again, the foreigner is faced with uncertainty when investing in the United States and this perception is amplified abroad where the FIRPTA law as a whole is regarded as vague and even dangerous.

Major confusion has been created by FIRPTA in the area of tax free reorganizations and other non-recognition transactions. The applicable FIRPTA provisions have not yet been regulated even though the statute calls for regulations. The following facts will illustrate some of the serious problems created by FIRPTA. Consider a Panama holding corporation which owns several foreign entities plus five U.S. subsidiaries. Two of the subsidiaries own appreciated U.S. real property and taken together, the non-US real estate assets of all five domestic entities amount to more than 50% of the total assets pursuant to the valuation methods prescribed in the Proposed Regulations. The client wanted to create a domestic holding company in order to enable its U.S. subsidiaries to file a consolidated U.S. tax return. If the shares of the domestic holding company are not shares of a U.S. Real Property Holding Corporation then according to IRC Sec. 897(e)(1) it would appear that non-recognition provisions would not apply and the transfer of the shares of the subsidiaries with appreciated real property would be a taxable event. However, if the transfer is treated as a distribution by a foreign corporation under IRC Sec. 897(d)(1)(B) then the transfer may not be taxable. If the valuation methods prescribed in the Temporary Regulations are used, the mortgages would be included in the fair market value of the U.S. real estate, in which case the U.S. real estate assets of the domestic holding company would exceed 50% of total assets and the shares of the domestic holding company would constitute a USRPI. Consequently, the transaction might not be taxable under Sec. 897(e)(1). Without final regulations and examples it is difficult to determine what the Treasury's position would be. Consequently, the foreign investor must accept an unascertainable contingent liability with respect to this transaction.

FIRPTA CONTAINS MANY INEQUITIES

There are many inequities contained in the FIRPTA law itself. For example, suppose a foreigner sells the shares of a Florida corporation which owns U.S. real property with a ~~basis~~ FAIR MARKET VALUE (FMV) of $150,000 and foreign situs real property with a ~~basis~~ FMV of $149,000. Any gain realized on the sale of the sale of the shares of the Florida corporation is fully taxable in the U.S. Thus, even though all the gain realized by the transaction is attributable to appreciation of the foreign situs or other non-U.S. real estate assets, all such gain would be taxed in the U.S.! This is clearly an unintended extension of the United States taxing jurisdiction which is clearly inhospitable to foreign investors.

FIRPTA ENCOURAGES TREATY SHOPPING

Another unintended result of FIRPTA is that it encourages treaty shopping. Under the law certain non-recognition provisions with respect to capital gains realization and other important elections, i.e. (Sec. 897(i) election), are afforded only to certain U.S. treaty partners. In order to obtain these benefits the foreign investor must forgo the possibility of investing through a corporation incorporated in his home country jurisdiction and opt for a treaty country corporation to serve as an investment vehicle.

FIRPTA LOOPHOLE CANNOT BE CLOSED

There are still glaring loopholes in the FIRPTA law which cannot be closed. For example, the sale of foreign corporation shares is exempted from FIRPTA taxation. The fact that FIRPTA can be so easily circumnavigated legally creates the general impression abroad that other U.S. tax laws can be avoided just as easily.

FIRPTA WITHHOLDING: NO SOLUTION

In my opinion, the amendment of FIRPTA to include withholding provisions would not remedy the situation. The amount of withholding is arbitrary and discriminatory against foreigners in that it denies the foreign seller the use of the withheld funds prematurely. The mechanisms of withholding would necessarily complicate real estate transactions by (1) creating a withholding liability in a U.S. person and/or (2) tainting the title to property with an unascertainable contingent liability if title had ever been held by a foreigner.

I have carefully reviewed Senate Bill No. 2062 and the Florida Bar's proposed revisions. The proposals are complex, both in theory and practice. Most of the provisions in the proposals require the Treasury to prescribe additional regulations. Is there any reason to believe that these regulations will be issued before 1990? In the meantime, practitioners and foreign investors will remain uncertain about the taxability of certain transactions and procedures such as: the methodology for obtaining a reduction in the flat withholding rate,[2] how refunds may be obtained,[3] the calculation of the taxpayer's maximum tax liability,[4] withholding procedures and liabilities affecting domestic partnerships, trusts and estates,[5] withholding procedures and liabilities affecting certain distributions by foreign corporations,[6] etc.

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[2] Florida Bar proposed IRC Code Sec.1444(c)(1)(A).

[3] Ibid. Sec.1444(c)(1)(C).

[4] Ibid. Sec.1444(c)(1)(C).

The withholding rate of 28% of the gross sales price is onerous. A reduction to 10% is a slight improvement, but this amount may equal the entire downpayment for a property. If the seller has generated any losses which might shelter his capital gain, these losses would not affect the withholding rate. The withholding rate may be adjusted if the IRS is petitioned in advance. The proposed bill would require the IRS to act within 15 days of the submission of the request.[7] It is ludicrous to presume that the IRS could respond to a petition within 15 days; and, moreover it is not clear how the withholding rate will be affected if the IRS fails to respond within 15 days.

It is not clear how the withholding proposals affect taxable transactions which do not involve cash. A U.S. person receiving U.S. real estate in an exchange is treated as a transferee who must withhold. As a result, even when no cash is exchanged the U.S. person must withhold!

Consider another example. A foreigner is unable to meet mortgage payments on his U.S. real property and the U.S. bank is forced to foreclose. The bank will be considered a transferee and will be subject to withholding obligations. However, the bank parted with its money years before the foreclosure. Will the bank be required to come up with more money to meet the withholding tax?

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[5] Ibid. Sec.1444(e).

[6] Ibid. Sec.1444(f).

[7] Ibid. Sec.1444(e)(3)(B).

I submit that even though the Treasury is capable of issuing regulations which might resolved these technical problems, there is no reason to believe that such regulations will be published on a timely basis. Meanwhile, the withholding provisions will only compound an already chaotic situation.

The proponents of the revised Senate Bill added a provision which would supposedly solve the investor's anonymity problem by proposing that the 10% tax withheld upon a disposition should constitute satisfaction of the entire tax obligation of the foreign seller.[8] Consequently, the foreign seller would not be required to file a tax return. Thus, if the foreign seller settles for the 10% withholding rate and is willing to forego the possibility of a reduction of the withholding rate or a refund, then anonymity of the seller can be preserved. The message to the foreign investor is clear: anonymity may only be preserved at a premium. Unfortunately, the foreigner will never be able to accurately calculate the cost of this premium at the outset of his investment. In contrast, the cost of arranging a Security Agreement pursuant to the provisions contained in IRC Sec.6039C could be estimated at the outset of the investment.

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[8] Ibid. Sec.1444(d).

The withholding proposals will not alleviate the many practical problems created by FIRPTA which tend to clearly discourage foreign investment in U.S. real estate. Instead, the withholding proposals will compound the already chaotic situation which FIRPTA has created.

FIRPTA: ACTUAL COST

The costs of administering the FIRPTA law will be excessive. If the law is to be enforced and not just flaunted hundreds of specially trained agents will need to be employed by the IRS. If prominent tax experts have difficulty determining when gains are realized and when taxable dispositions take place, it is not likely that the average IRS agent will fare any better.

CONCLUSIONS

It has been my observation that the enactment of FIRPTA has made a bad situation worse. Foreign capital has maintained many real estate markets in this country. The decline of foreign investment has damaged these markets and FIRPTA has clearly contributed to this injury. My opinion is based upon my involvement in thousands of transactions involving foreign investors and U.S. real estate.

The original goal of establishing parity between the foreign and U.S. investor is unattainable. FIRPTA contains many discriminatory and even punitive provisions which affect a narrow group of foreign investors. As the discriminatroy characteristics of FIRPTA continue to emerge, the perception of discriminatory U.S. tax treatment of foreigners will be amplified abroad.

The FIRPTA law creates significant legal and financial uncertainties which also dampen the U.S. investment climate. Final Regulations are long overdue. Withholding proposals for FIRPTA require additional regulations. Competent tax attorneys have trouble determining when taxable dispositions occur, when non-recognition provisions of the Code apply, how Security Agreements should be drafted, and the list goes on and on.

The final reminder that FIRPTA is folly should come to light when the real costs of administering the law are finally calculated. Hundreds of new agents will be needed to effectively enforce and monitor this law. The additional paperwork generated by the FIRPTA reporting provisions have far exceeded the IRS's expectations. However, the most expensive item will be the loss of foreign capital caused by FIRPTA. In an era where the U.S. government is pouring billions of dollars into foreign aid overseas, the private sector should be given every opportunity to repatriate these dollars.

Senator WALLOP. Mr. Richards, was there one additional point that was in that page? We haven't many witnesses, if you wish to make the statement.

Mr. RICHARDS. The revenue effect projected under the original withholding provisions estimated that a total of $104 million would be derived from the withholding provisions from 1984 through 1989, based on a tax obligation of 28 percent. I believe that the Florida bar proposal, which may be adopted by the committee, has a provision which makes the maximum tax of a foreign investor 10 percent of the total sales price. I believe that this substantial change in the law would require a reduction of this revenue projection.

Thank you.

Senator WALLOP. Thank you, Mr. Richards.

Senator Bentsen has joined us and he has another obligation to attend to at approximately 11. And he has some comments that he wishes to make and perhaps some questions.

Dr. Hillman, if you would indulge me. I will let Senator Bentsen proceed at this moment.

Senator BENTSEN. Thank you very much, Mr. Chairman.

I regret I couldn't have been here at the beginning, and I won't be here at the end. But we have the tax conference underway in the House and Senate. We are once more simplifying the tax code. We are adding another 1,300 pages. [Laughter.]

I voted for Senator Wallop's bill because the concern at that time was the question of young people being able to buy a farm. That's really where the support came from, and it was a legitimate concern. That has turned around 180 degrees now.

The people who are doing the most business, for example, in west Texas are the auction houses selling out farmers. And it's not just windshield farmers who drive by and look at the crops and have some tenant doing it. It's third generation families losing them. And you are seeing a plummeting of farm value, 20, 30 percent.

And what you really need, I think, is some long-term capital in there to help support these markets. And that's what we see coming from abroad.

One of the problems that you run into with major investment trusts is that if there is a degree of uncertainty in the law, and even in the interpretation of those laws, they say, well, why bother; let's go some place else and invest our capital.

One of the great strengths of this country has been the way it has treated capital and the mobility of capital and the depth and the breadth of our financial markets. Last year we had over $30 billion in net inflow. We think interest rates are high, but where would they have been if we had not had that. They assist in this regard.

Senator Chafee and I are the principal cosponsors of the repeal of the withholding tax, 30 percent withholding tax, on long-term securities. This goes absolutely in the opposite direction. Once again there we were trying to encourage capital to come into this country, and trying to keep interest rates down for our own people.

I think that we have reached a point where we ought to repeal this particular provision. And I would even go so far to say that is true on agricultural real estate. And I have a State that is first or second in the way of production on agriculture, depending on how you want to figure it. So it's a major concern.

And I think when I say that I'm helping citizens of my State and those in agriculture. Because if you can keep those farm values stable, then the bankers are not going to feel like they have to foreclose that farmer because they will see that that value is there.

So I would hope as we go through these hearings that that case will be built, and I think it will from what I see of the quality of the witnesses, and that we will be able to prevail, Mr. Chairman. And I congratulate you on holding these hearings. I hope that we will be able to prevail on this issue and change the law; particularly, because of the fact that we have had changing conditions. And in the long run interest for this country, we ought to continue to promote free access of money, capital flowing in—and flowing out if that is desired.

As long as it has those kinds of assurances of freedom of movement, we will have the kind of stability we are seeking. And we won't have the kind of pockets of price changes that develop in the short run.

I have always been told in real estate that you have got to have staying power to take care of these little valleys. I think investment trusts often represents that kind of capital, particularly on real estate because they are not fast in and out for fast bucks.

So, again, Mr. Chairman, I hope that the ultimate decision will be to repeal it. Again, I do wish I could stay the whole time, but I have to get back to the tax conference.

Senator **Wallop**. Well, thank you. I mentioned before you came in that sometimes the solution to a problem creates a greater problem than the one with which we started. And that may well be the case here. I'm certainly approaching this with an open mind. I, like you, have noticed the decline in agricultural real estate prices in my State.

Senator **Bentsen**. Look at what has happened to oil and gas properties. And I know that is not going to last. But nevertheless during that period of time you have seen some almost catastrophic things happen to the small companies that were in that business. And you are seeing a real recession there. And I think once again that you add some stability if you have an access to capital.

Senator **Wallop**. You and I will recall that our original purpose was entirely narrow compared to the ultimate offspring which grew from it. I likened it this morning before you came—I feel as though I have sired a son who was kidnaped and after 4 years of careful police work, was returned as a guerrilla, and I didn't want him back.

Senator **Bentsen**. I can't wait until they get through writing the regulations for the taxes we are passing over there right now.

Senator **Wallop**. I can. [Laughter.]

Thank you very much.

Mr. **Knight**. Mr. Chairman, with the permission of Dr. Hillman, may I make one brief comment?

Senator **Wallop**. Yes.

Mr. **Knight**. Our experience has been that foreign investors who buy farm property here typically employ the farmer who previously owned the property to run the farm. They typically go down to the local farm equipment store and buy a lot of shiny new equipment that perhaps wouldn't have been bought. And that's certainly putting dollars in our economy. I think this is probably, as you suggested, an advantage to our economy.

But the critical and ironic point from a tax standpoint with regard to FIRPTA is this: The largest single loophole in FIRPTA is that a foreign investor can still buy a farm here and sell that farm free of any capital gains tax even after FIRPTA by the simple expedient of organizing a foreign corporation, having that foreign corporation hold the farm, and later selling the shares in the foreign corporation to another foreign person or even a U.S. person, the point being that the purchaser of a farm typically—because there are no depreciable aspects or very few to a farm—doesn't need to step up the basis.

So you can have a chain of sales of this kind and never pay a FIRPTA tax, notwithstanding the fact that the original purpose of FIRPTA was the expressed desire to tax foreign investors on their farmland gains.

Senator BENTSEN. I was aware of that. But, once again, you shouldn't have to go to an extreme to avoid that.

Mr. KNIGHT. One further point on the stock sale. As you know, FIRPTA tries to reach, not the sale of shares of foreign corporations, but the sale of the shares of U.S. corporations owning U.S. real estate or foreign corporations that have made a domestication election under FIRPTA.

The Treasury report of 1979 specifically said that this kind of an attempt to reach gain realized by foreign investors from the sale of shares would represent a departure from international norms. We have gone way beyond any other area of our tax law with FIRPTA. A foreign investor who owns a U.S. manufacturing subsidiary here which is actively engaged in manufacturing or engaged in any other commercial business, can sell the shares of that subsidiary free of U.S. tax. It seems to me that FIRPTA has gone to great extremes to tax real estate and that this can have nothing but a discouraging effect. We are sending out the signals that we wish to discourage foreign investment in real estate.

Senator WALLOP. Thank you very much.

STATEMENT OF DR. JIMMYE HILLMAN, CHAIRMAN, DEPARTMENT OF AGRICULTURAL ECONOMICS, UNIVERSITY OF ARIZONA, TUCSON, AZ

Senator WALLOP. Dr. Hillman.

Dr. HILLMAN. I think what I'm going to say, Mr. Chairman, has been said so eloquently by Mr. Bentsen, but having come all the way from Tucson, I will say it anyway. It's a real pleasure for me to have this opportunity to appear before you. And my remarks will be limited principally to agricultural, ranch and related areas affected by the issue at hand. I don't wish to pose as a tax expert, yet in matters of agricultural policy, I do have some experience.

Now the first part of my written testimony reviews the attitude toward the land in this country with respect to economic development; the fact that our laws have encouraged land distribution and diverse ownership in the past, and the fact that foreigners have always played a very large role in our farm and ranch land. That is, at least in the founding of the country through the railroad, through the plantations, through the ranches, et cetera.

But I wish to spend most of my time in turning to the recent controversy over foreign land ownership. Now I have a table in my testimony that updates what Senator Goldwater said a while ago. It's as of 1980 and through 1982 that the foreign ownership of non-Federal land available for agricultural purposes is just a little less than 1 percent in tables 2 and 3 of that presentation.

The value—and this I think is an important point—of all agricultural land in 1983 was around $700 billion. The relative land values between farmland and the equity market it still holds, even approximately to what they were several years back, amounts to as much as all the capital assets of the top 200 corporations listed in the Fortune 500.

Thus, it might be asked just how foreigners are going to commence to pay a debt on any significant portion of such vast holdings. I think many people do not realize just how much money there is involved in the agricultural real estate. As to land markets, the United States stands out as having a relatively open and free market in agricultural real estate. I have lived and worked in many foreign countries and it's noticeable that there is very little "open" land market compared to this country.

Many of us who have lived through various cycles of agricultural fear and concern always want to get at the basic cause of these concerns. In my opinion, the mere fact of foreign ownership of farmland is not the principal bogyman for U.S. agriculture today. Other facts have been and are now far more important.

I thought this in the mid-1970's when we were going through this uproar, and I am on record as having spoken against much of what we went through and many of the actions that we took at that time. I still think it today. There was anxiety over food supplies and related matters, and with respect to agricultural policy, I think we were then, and we are still chasing the wrong phantom.

Responsible studies show that of all the farmland that changes hands, approximately 75 percent of land that changes hands is purchased by the farmer next door or in the same vicinity. It's not some unimaginable phantom or foreign investor. To be sure, during the mid to late 1970's, when the dollar was depressed, when the dollars were being recycled, when inflation was rampant abroad in the United States, and when investors were nervous, the profitable haven was U.S. farmland. As we how witness, the reverse trend has set in. Of particular interest is that the average price of U.S. farmland has declined for the third year in a row, a phenomenon which has not occurred for 50 years, or since the Great Depression.

My question is: Where are all those foreign investors when we need them.

I have little fear that foreign investors can outbid U.S. farmers for their real estate if farming and ranching are profitable. There's the rub. Indeed, we have heard less and less about the problem of foreign investment in farmland recently because foreigners, like American farmers, are again discovering the facts of life about the vagaries of agricultural enterprise. It's a very costly proposition to own and operate large acreages of high priced farm and ranch land. Hence, I do not agree that it is more economic, other things being equal, for foreigners to own and operate U.S. farms and ranches. Moreover, the fear that foreigners could somehow jeopardize our food supply in this manner is without foundation.

One major cause of the current farm trauma in the United States is depressed land prices which were bid up too high during the mid-1970's. And as I intimated a while ago, Mr. Chairman, I was one voice crying in the wilderness. I was out in Iowa making several speeches during 1974 and 1975 pointing this out.

There is little research evidence however to show that this problem was either caused or exacerbated by a massive inflow of foreign capital. Contrariwise, we must not expect a miracle to happen to farmland prices if we should return to all the conditions which existed before the passage of the Foreign Investment and Real Property and Tax Act.

When FIRPTA passed, we knew little about the extent of foreign ownership. Moreover, the legislation was enacted when land prices were inordinately inflated. Additional foreign capital would probably now assist American farmers in the current depressed land market. In sum, however, it would be unwise to attribute to FIRPTA either too much positive or negative influence on the price of agricultural land.

There are a couple of basic principles which I would like to point out with respect to agricultural policy which need attention, and which I would like to emphasize.

Relatively free, competitive markets—domestic as well as foreign—subject to minimal intervention for income support, or in some cases income stabilization is what we need in American agriculture.

A general commitment—for social as well as political and economic reasons—to a certain preponderance of the so-called family farm over and against corporate and absentee-owned farms.

And, finally, an open door to capital investment—foreign and domestic—so as to adequately finance U.S. agriculture.

No doubt FIRPTA interferes with the farm real estate market, but as yet research studies have not produced definite answers as to how much. As to the tax provisions of the act, I should like to defer to the experts for fact and opinion. As an observation, I believe that we must also be concerned about State laws and regulations so they do not unduly restrict foreign investment.

FIRPTA and many State laws were passed during and after a period of national worry about foreign ownership of real estate. Insofar as this concern relates to farming and ranching and agricultural policy, I conclude that this worry is unfounded. I shall continue, as I have in the past, to question national laws that are designed to restrict both international trade, of which I am more of an expert perhaps than in the land, and foreign investment.

Thank you, Mr. Chairman.

Senator WALLOP. Dr. Hillman, thank you.

[The prepared written statement of Dr. Hillman follows:]

STATEMENT OF DR. JIMMYE S. HILLMAN

FOREIGN OWNERSHIP OF UNITED STATES AGRICULTURAL LAND*

Mr. Chairman, I wish to thank you and the Committee for this opportunity to appear before you. My remarks will be limited principally to the agricultural and related areas affected by the issue at hand. I do not pose as a tax expert; yet, in matters of agricultural policy, I have some experience.

Arguments over land questions are not new; they began with the founding of the Republic. Abundant land served as a stimulus to the development of the nation from the very beginning. Land was the real magnet that drew settlers to America, particularly after the myth about quick riches had been exploded. The Public Doman lay at the heart of American history for a hundred or more years after the Declaration of Independence. From the beginning, therefore, there was a peculiar volatility about the land question.

As of 1956 the distribution of the Public Domain by the Federal Government had taken place as per Table 1.

Since the objectives of the federal government in the disposition of public lands were never articulated clearly, the first big argument was between Alexander Hamilton and Thomas Jefferson. Hamilton and his supporters held that the new government needed money to operate and that land should be sold in large tracts at prices that would bring in much needed revenue. The opposing view -- that of Jefferson -- was that the public lands should be given to settlers free of charge. The struggle continued for years with each side winning a bit in the Land Act of 1796 when the minimum price at which land could sell was raised to

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*Testimony given by Dr. Jimmye S. Hillman before the United States Senate Committee on Finance on S.1915, June 19, 1984.

Table I. Distribution of the Public Domain by the Federal Government, as of 1956

Land Category	No. of Acres (Millions)
Land disposals	
Direct grants to railroads	131.0
Grants to states to support education	99.0
Grants to states to support transport and other internal improvements	125.0
Military land bounties	73.5
Homestead and related grants	147.0
Sales and grants primarily to private individuals	455.5
Total disposals	1,031.0
Indian tribal and trust lands	52.8
Reserved for national forests, parks, wildlife, national defense, and other purposes	187.8
Unreserved and unappropriated public domain	170.6
Grand total original public domain	1,442.2

Source: Cochrane, Willard W., The Development of American Agriculture: A Historical Analysis, University of Minnesota Press, Minneapolis, Minnesota, 1979

$2.00 per acre. The quest for cheap or free land did not evoke the best in American citizenry. It has been said that every corrupt practice ever conceived came into play in the disposal of the public lands.

The second major point to be made is that, from the beginning, foreigners were encouraged to invest in American land. This came about several ways. For example, through the railroads. Railroads developed partially with the assistance of direct land grants from the federal government. Foreigners -- British, French, German -- invested in railroad construction, hence, indirectly became large land holders.

While foreign investment tended to be concentrated in land through railroads and canals ownership, it also found its way directly into farm and ranch land holdings. The British, in particular, invested in cotton plantations to feed their textile industry. Many of these operations were held until W.W. I and W.W. II foreced their liquidation so as to finance the war efforts. In the post-Civil War period, foreign investment tended to become more diversified, but it is interesting to note that large amounts of British capital were invested in -- and lost in, we may observe -- large ranching enterprises in the Far West.

The historical significance of foreign-invested capital in United States agricultural land development is open to debate, but there is little doubt that it played a role -- perhaps a significant role at times. Certainly there were times when the role of foreign ownership was more significant, relatively speaking, than it is today!

In sum, for the period up to 1900 the main elements of national land policy, though not always expressly formulated by Congress, were in broad outline the following:

1. Rapid settlement and development of the nation's land resources;

2. Except in the South and in parts of the West, development of the Nation's agriculture on a family farm basis;
3. Ownership by the operator of the farm;
4. Abstention from coercion in changing patterns of land ownership and tenure relations for lands not owned by the government;
5. Complete freedom for the individual to alter the size of farm and type of tenure envisioned at the time the land was alienated from the public domain;
6. Freedom to produce whatever kinds and amounts of products that operators and owners might choose to produce;
7. Freedom to depreciate, build up, or destroy soil resources as the owner might choose.

Freedom of action by the individual and very little governmental regulatory action were the dominant characteristics of the land policy. Except in the South and in parts of the West, the family unit generally proved to be relatively efficient. The above policy was a natural and probably a logical one for a pioneer country rich in resources, short on manpower, and heavily imbued with the economic policy of laissez faire.

The United States Agricultural Land Market

I wish to turn now to the recent controversy over foreign land ownership in the United States. As we can see from Table 2, the most recent data show that there are 1,359 million acres of nonfederal land available for agricultural purposes. Foreigners in 1982 owned 13,461 thousand acres of agricultural land or approximately one percent. (Table 3)

Table 2. AVAILABILITY OF NONFEDERAL LAND FOR AGRICULTURE: 1977

(In millions of acres. Agricultural lands represent lands currently used to produce agricutlural commodities. Data are based on National Agricultural Lands Study; for details, contact source)

State	LAND AVAILABLE FOR AGRICULTURE				Land not available for agriculture	State	LAND AVAILABLE FOR AGRICULTURE				Land not available for agriculture
	Total[1]	Cropland	Rangeland	Forest land			Total[1]	Cropland	Rangeland	Forest land	
U.S.	1,359	413	414	376	153	Mo.	39	15	(z)	11	3
						Mont.	64	15	39	6	2
Ala.	29	4	-	20	3	Nebr.	47	21	22	(z)	2
Alaska	13	(z)	6	7	1	Nev.	9	1	7	(z)	2
Ariz.	38	1	35	2	2	N.H.	4	(z)	-	4	1
Ark.	28	8	(z)	14	2	N.J.	3	1	-	2	2
Calif.	39	10	18	10	15	N. Mex.	48	2	42	3	3
Colo.	40	11	24	3	3	N.Y.	25	6	-	15	6
Conn.	2	(z)	-	1	1	N.C.	25	6	-	17	4
Del.	1	1	-	(z)	(z)	N. Dak.	41	27	11	(z)	2
Fla.	24	3	3	12	8	Ohio	21	12	-	6	5
Ga.	32	6	-	22	4	Okla.	40	12	15	5	2
Hawaii	3	(z)	-	1	1	Oreg.	27	5	10	10	2
Idaho	18	6	7	4	1	Pa.	23	6	-	14	6
Ill.	31	24	-	3	4	RI	(z)	(z)	-	(z)	(z)
Ind.	20	13	-	4	3	SC	15	3	-	11	3
Iowa	33	26	-	1	2	S. Dak.	44	18	22	(z)	2
Kans.	49	29	16	1	2	Tenn.	22	5	-	12	3
Ky.	22	5	-	11	2	Texas	155	30	95	9	10
La.	22	6	(z)	13	6	Utah	13	2	9	1	4
Maine	18	1	-	17	2	Vt.	5	1	-	4	1
Md.	4	2	-	2	2	Va.	20	3	-	13	3
Mass.	3	(z)	-	3	2	Wash.	28	8	6	12	2
Mich.	27	9	-	15	6	W. Va.	13	1	-	10	1
Minn.	41	23	(z)	14	6	Wis.	29	12	(z)	13	4
Miss.	26	7	(z)	14	3	Wyo.	31	3	26	1	2

- Represents zero   Z less than 500,000 acres   [1] Includes pastureland and other land in farms not shown seperately.

Source: U.S. Dept. of Agriculture, Soil Conservation Service. Resources Conservation Act Appraisal, 1980.

Table 3. FOREIGN OWNERSHIP OF U.S. AGRICULTURAL LAND: 1982

(In thousands of acres, except percent. Covers "Foreign persons" reporting under the Agricultural Foreign Investment Disclosure Act of 1978. As defined in the Act, a "foreign person" is any person who is not a U.S. citizen and who is not a permanent resident alien of the U.S. Foreign governments and entities are also "foreign persons." Also, each successive link in a chain of U.S. entities containing foreign interests is considered a "foreign person." An entity is deemed a "foreign person" because another "foreign person" holds at least a 5 percent or more interest in the entity. Therefore acreage figures reported do not necessarily mean that they are wholly owned by foreign investors.

Characteristic	Acreage Owned[1]		Acreage Acquired[2]		Characteristic	Acreage Owned[1]		Acreage Acquired[2]	
	Total	Percent	Total	Percent		Trade	Percent	Trade	Percent
Total[3]	13,461	100.0	576	100.0	Country of foreign owner:				
Type of owner:					Canada	1,445	10.7	71	12.3
Corporation	11,193	83.1	402	69.8	Germany, Fed. Rep.	675	5.0	60	10.4
Partnership	1,238	9.2	95	16.5	Hong Kong	176	1.3	-	-
Individual	860	6.4	72	12.5	Mexico	211	1.6	3	.5
Other	170	1.3	7	1.2	Netherland Antilles	532	4.0	15	2.6
Size of holding:					Switzerland	237	1.8	8	1.4
Less than 100 acres	115	.9	7	1.2	United Kingdom	381	2.8	7	1.2
100-299 acres	259	1.9	22	3.8	Through U.S. interest:[4]				
300-999 acres	779	5.8	80	13.9	Canada	2,656	19.7	16	2.8
1,000 acres or more	12,308	91.4	467	81.1	France	304	2.3	20	3.5
Land use:					Germany, Fed. Rep.	480	3.6	50	8.7
Cropland	1,803	13.4	126	21.9	Hong Kong	1,692	12.6	-	-
Pasture	3,000	22.3	99	17.2	Luxembourg	236	1.8	-	-
Forest	7,449	55.3	281	48.9	Netherlands				
Other agriculture	545	4.0	29	5.0	Antilles	508	3.8	5	.9
Other nonagriculture	664	5.0	41	7.0	United Kingdom	1,505	11.2	43	7.5

- Represents zero. [1] Landholdings by foreign interests as of Dec. 31. [2] Acquisitions by foreign interests from Jan. 1-Dec. 31, 1982. [3] Includes other items not shown separately. [4] Reports filed by U.S. corporations with foreign shareholders

Source: U.S. Dept. of Agriculture, Economic Research Service, Foreign Ownership of U.S. Agricultural Land through December 31, 1982 (Economic Research Service Staff Report AGES 830310), 1983.

The value of all agricultural land in 1983 was $668 billion. If relative values between farm land and the equity market still hold, even approximately, to what they were several years back, this amounts to as much as all the capital assets of the top 200 corporations listed in Fortune 500. Thus, it might be asked just how foreigners are going to finance and carry debt on any significant portion of such vast holdings?

As to land markets, the United States stands out as having a relatively open and free market in agricultural real estate. I have lived and worked in many foreign countries and it is noticeable that there is very little "open" land market. This is particularly true in Europe and Japan where one has to look very closely to discover changes in land ownership. Most changes take place within families, or between family members. Of course, behind the Iron Curtain there is no private land market. And look at the productivity of Communist agriculture!

Many of us who have lived through several cycles or variations of agricultural fear and concern always want to get at their basic cause. In my opinion, the mere fact of foreign ownership of farm land has not been the principal bogeyman. Other factors have been and are now much more important. I thought this in the mid-1970's when there was such an uproar over foreign control of agricultural property, such anxiety over food supplies, and related matters. I still feel the same way. With respect to agricultural policy problems, we were chasing the wrong phantom.

Responsible studies show that of all the farm land that changes hands, more than 75 percent is purchased by the farmer "next door". To be sure, during the mid-to-late 1970's when the dollar was depressed, when petro dollars were in abundance and were being recycled, when inflation was rampant abroad and in the United States, and when investors were nervous, a seeming safe and profitable haven was U.S. farm land. As we now witness, the reverse trend has set in. Of particular interest is that the average price of U.S. farm land has declined for the third year in a row, a phenomenon which has not occurred for 50 years, or since the great depression. Where are those foreign investors when we need them?

I have little fear that foreign investors can outbid U.S. farmers for their real estate if farming and ranching are profitable. There's the rub! Indeed, we have heard less and less about the problem of foreign investment in farm land recently because foreigners, like American farmers, are again discovering the facts of life about the vagaries of agricultural enterprise. It is a very costly proposition to own and operate large acreages of high priced farm and ranch land. Hence, I do not agree that it is more economic, other things being equal, for foreigners to own and operate U.S. farms and ranches. Moreover, the fear that foreigners could somehow jeopardize our food supply in this manner is without foundation.

One major cause of the current farm trauma in the United States is depressed land prices which were bid up too high during the mid-1970's. There is little research evidence, however, to show that this problem was either caused or exacerbated by a massive inflow of foreign capital. Contrariwise, we must not expect a miracle to happen to farm land prices if we should return to all conditions which existed before the passage of the Foreign Investment in Real Property and Tax Act, FIRPTA. When FIRPTA passed, we knew little about the extent of foreign ownership. Moreover, the legislation was enacted when land prices were inordinately inflated. Additional foreign capital would probably assist American farmers in the current depressed agricultural land market. In sum, however, it would be unwise to attribute to FIRPTA either too much positive or negative influence on the price of U.S. agricultural land.

Agricultural Issues: Basic Principles

When Congress first conducted hearings to investigate foreign investment in farm land, they were given some rather alarming estimates and dreadful predictions. In some places, 40 percent of land sales were said to involve foreign persons -- perhaps 20 percent nationally -- and foreign holdings of prime farm land were thought to be multiplying rapidly. Results of official studies undertaken by the General Accounting Office (GAO) and the USDA, in accordance with the Agricultural Investment Disclosure Act (AFIDA) considerably allayed those fears, showing that they had little basis in fact. Local studies also showed that worries about the sale of farm land to foreigners were greatly exaggerated.

For the record, it should be recognized that AFIDA has had problems in creating a reliable system for monitoring foreign investment. Our experience studying foreign investment in Arizona and the discrepancies in USDA reports verify this. Also, there is an admitted inability to detect the investors who really wish to conceal their identity. These inefficiencies in AFIDA do not disturb me, because, as already stated, I do not view foreign investment as the most pressing concern for farm policy.

The basic principles of agricultural policy which need attention and what I should like to emphasize are:

1. Relatively free, competitive market -- domestic as well as foreign -- subject to minimal intervention for income support, or in some cases income stabilization;

2. A general commitment -- for social and political as well as economic reasons -- to a certain preponderance of so-called family farm over and against corporate and absentee-owned farms;
3. An open door to capital investment -- foreign and domestic -- so as to adequately finance United States agriculture.

No doubt FIRPTA interferes with the farm real estate market, but as yet research studies have not produced definite answers as to how much. As to the tax provisions of the Act, I should like to defer to the experts for fact and opinion. As an observation, I believe that we must also make sure that state laws and regulations do not unduly restrict foreign investment.

FIRPTA and many state laws were passed during or after a period of national worry about foreign ownership of real estate. Insofar as this concern relates to farming and ranching and agricultural policy, I conclude that this worry is unfounded. I shall continue as I have in the past, to question national laws that are designed to restrict international trade and investment.

Senator WALLOP. You know one of the things that occurs to me is that there is some undercurrent which is probably very difficult to get a handle on.

You have on the one hand, Mr. Knight, a revenue projection which all would agree is relevant based on this factor that was 28 percent at the time. But there is some undercurrent here that there is perhaps a dynamic effect of revenue loss. I don't know if it's possible to get to that in anyway, to strengthen the case in the time of budget deficits. But if it can be demonstrated that it is either revenue neutral or costing us revenue because of the disincentive to investment created (a) by uncertainty; and (b) by the certainty that if it is pursued as it presently appears to be that there will be a decline in transactions.

It would be helpful in making this case.

Mr. KNIGHT. I certainly cannot quantify the kind of disincentive you are suggesting may produce less revenue finally to the government, but I can say from personal experience that I know a number of instances where foreign clients represented by our firm, both private and institutional, have chosen quite clearly, because of FIRPTA, to divert their investment from U.S. real estate to such investments as U.S. portfolio holdings and the like where they know full well they will have *x* return and they will have no capital gains tax when they sell their shares. I know of a number of those instances. And I seriously question whether that's in the national interest.

Senator WALLOP. One of the problems that we have on this committee—and I don't know the resolution of it. I only know that it exists—is that we are always faced with a static revenue figure. And it's not possible for us to reach into the speculative realm of dynamics; the effects of any given tax policy, whether FIRPTA or any other thing.

Mr. **Knight**. It is true though, I would suggest, Mr. Chairman, that the administration and I think quite properly so, and Senator Bentsen has indicated his support, is strongly supporting the repeal of the withholding tax on portfolio investment and has specifically indicated that this support is not founded on whether or not there will be a revenue gain or loss but is founded on economic policy considerations and questions of the efficiency of the international markets. I think the same kind of policy considerations can be made in favor of the repeal of FIRPTA.

Senator **Wallop**. I thank you very much.

Mr. Emerson, will you testify?

Mr. **Emerson**. No, sir.

Senator **Wallop**. I appreciate the testimony that you have each given. I would think that there is the possibility that a number of agricultural groups might look at the testimony that you gave this morning and perhaps weigh in on the side that it is in the long-term interest of their interests. A narrow economic one, but narrow in terms of definition of agricultural real estate as well. We will have to see that but it is certainly an inquiry I will make of them to see how they react.

Dr. **Hillman**. Senator, it needs to be said loud and clear—and I hate to say I was right in the mid-1970's when all of this was going on. But the real problem in American agriculture is not foreign investment. It's high interest rates and a variety of other things which relate to the agricultural commodities. Whereas this would help a great deal, the repeal of FIRPTA, with that in mind.

We have other problems in agriculture which should be considered. And we need all the capital that——

Senator **Wallop**. Even at the time when I was the principal force behind this, that's my recognition of that. That the problems of agriculture certainly were not going to be solved, if this worked in its entirety the way some of us had anticipated that it might. I come from agriculture and I know the business better than most in Congress. But in point of fact in a time of highly escalating land values, as we saw in the late 1970's, there was a certain circumstance there that was pretty tough, especially if you get into this environment of Washington, DC, where these land prices were escalating. And the tax structure at the time would have permitted a foreign investor to bid as much as 15 percent more for a given piece of property than the neighboring farmer would have been able to bid on it. It was just related to that. And it gave them the staying power that Senator Bentsen was talking about, to wait for the town to come out and realize enormous gains, not on agricultural investment, but on what was a real property investment in development at some time.

And those had a dimension on our thinking at the time, those circumstances. Where the benefit of hindsight has proved them to be real or imagined, the fact was that those advantages did exist, and they were harmful to Americans. It wasn't so harmful to the guy wishing to sell his property, but it was quite harmful to the neighbor that was next to him who might wish to acquire that and go on with agricultural production. That was part of what we were thinking of.

But as has been said by many, including myself, the concept of which we began left us somewhere in the early parts of that dialog, partly as a matter of definition. Nobody knew how to define agricultural land. And as you began to make the definition, as bureaucrats and politicians do, it got broader and broader and broader and ran away from us. We lost what we were originally trying to do.

Mr. **RICHARDS**. Mr. Chairman, I would like to briefly comment on the economics of FIRPTA and the revenue projections. FIRPTA is an extremely complex law. Competent tax practitioners are having difficulty determining when taxable dispositions are taking place. It will be necessary to hire dozens and dozens of specially trained IRS agents to administer this law. The cost of printing the forms and the cost of renegotiating dozens of tax treaties to bring them into conformity with FIRPTA, I submit to you will be a cost which will wash out many of the revenue benefits to be derived by FIRPTA for years to come.

Thank you.

Senator **WALLOP**. You have to pay them on one side or the other. It was not the intent.

Mr. **RICHARDS**. It seems unfortunate to have at the same time a Bureacratic Employment Act and a hot money encouragement act.

Senator **WALLOP**. Well, you have got to admit that it has done something for lawyers. [Laughter.]

Mr. **RICHARDS**. Yes. I think I'm appearing here testifying against my own self-interest.

Senator **WALLOP**. I appreciate your testimony this morning. Thank you very much.

We are next privileged to have two foreign guests and witnesses to testify as to their experience as to what this means to people who have large investment responsibilities for foreign capital in this country.

And the first is a colleague of sorts—Senator G.O.J. Van Tets of the Dutch Parliament on behalf of the European Federation for Retirement Provision, The Hague, Holland. Next will be Lord Mark Fitzalan Howard of London on behalf of the British Association of Investment Trust Companies and representative of the European Federation of Pension Funds in London.

I welcome you both. And, Senator Van Tets, please proceed.

STATEMENT OF HON. G.O.J. VAN TETS, SENATOR, DUTCH PARLIAMENT, ROTTERDAM, NETHERLANDS, ON BEHALF OF THE EUROPEAN FEDERATION FOR RETIREMENT PROVISION, THE HAGUE, HOLLAND

Senator **VAN TETS**. Thank you very much, Mr. Chairman. I am G.O.J. Van Tets, and I am pleased to appear today on behalf of the European Federation for Retirement Provision, Mr. Chairman, in support of Senator Goldwater's bill.

The European Federation for Retirement Provision is a federation of the national associations of private corporate pension funds in eight European countries. Among those eight European countries, especially in the United Kingdom and The Netherlands, to a lesser extent Ireland and Belgium, there are funds to invest substantial funds in this country. In this country there exist wide opportunities for more of that sort investment, if certain tax laws would be altered because there are still certain barriers to this type of investment for pension funds which are tax exempt in their own country which have not been fully dealt with under the various tax treaties.

Apart from the withholding tax on dividends and commercial real estate income, the situation in this respect has deteriorated substantially by the introduction of FIRPTA with all its complications and ramifications. Including the capital gains tax on commercial use. But also on capital investments such as venture capital investments such as participation in oil and gas exploration and high technology companies.

FIRPTA, as has been mentioned already by Mr. Knight, provides that existing international treaties be preempted after the first of January and pension funds were certainly stunned to learn that that could exist and that existing treaties could be overrided in that way.

We were also shocked by the idea that such tax could be imposed retroactively. After all, it was helpful to the United States markets, which was then in a depressed state, when investors from Europe did acquire property in a very substantial way in 1974, 1975. And for the resulting gains from that to be taxed retroactively on the basis of 1980 legislation, is considered by them unfair and not in keeping with what we would expect your Congress to do.

That is one point. The uncertainty which has already been pointed out, too, surrounding the whole action has also seriously dampened investment interest in direct investment, and will certainly continue to deter such investment unless the law is repealed or at least substantially modified.

The ramifications of FIRPTA even going to the extent that the funds would have to calculate the actuarial interest of certain beneficiaries in the fund, are sufficient to deter all medium-sized pension funds from investing in the United States, especially when they realize that apparently such legislation can be retroactive. And it gives a strong incentive to funds holding only limited interest at this time to dispose of it before the protection of the treaty runs out on the first of January next.

In any event, most pension funds, being tax exempt in their own countries, balk at being subjected to tax when investing in the United States. And I do wish to point out that the United States itself recognize their own domestic pension funds as eligible for tax exemption on exactly the same grounds on which our exemption is always based.

So after the cold shower of FIRPTA at the end of the Carter administration, we were encouraged by the introduction in Congress of various bills aiming to deal with some of that and with the pronouncements of the administration that they would rather see a free flow of capital throughout the world.

I would therefore hope that you will be able to act to modify this law promptly. It will be clear that although the repeal of FIRPTA will by no means deal with all of the problems which bona fide corporate pension funds come across as far as taxation is concerned, but it will go a long way toward alleviating these problems as far as direct investments in real estate.

I would like to emphasize what was already said by Senator Bentsen that reducing such barriers to investment access to the U.S. market is a much better way of encouraging investments than having to maintain high rates of interest, which in the long run would be harmful to both your economy and will——

The Federation, Mr. Chairman, therefore, strongly supports the initiative of the repeal of FIRPTA. I would like to reiterate that corporate pension funds ought to be exempt from all taxes on the same basis as your domestic pension funds. And I would like to submit a further written view on that subject for the record of this hearing.

Senator WALLOP. Of course, we will see to it.

[The prepared statement from Mr. Van Tets follows:]

EUROPEAN FEDERATION FOR RETIREMENT PROVISION

STATEMENT BEFORE U.S. SENATE COMMITTEE ON FINANCE

June 19, 1984

Hearings on S. 1915, a bill to repeal the
Foreign Investment in Real Property Tax Act

Mr. Chairman and Members of the Committee,

My name is Govert van Tets, and I am pleased to appear today on behalf of the European Federation for Retirement Provision (EFRP), in support of legislation (S. 1915) to repeal FIRPTA.

The European Federation for Retirement Provision is a federation of the national associations of private pension funds in eight European countries. Private pension funds investing substantially in the U.S. exist primarily in the U.K and the Netherlands, and to a lesser extent in Ireland and Belgium. In these countries, there is wide opportunity for more such investments in the U.S. if certain U.S. market and regulatory conditions are altered.

There are, however, certain U.S. barriers to this investment which have not been fully dealt with under the various tax treaties, apart from the withholding tax on dividends and commercial real estate income, the situation has deteriorated significantly by the enactment in 1980 of the FIRPTA legislation with all its complications and ramifications. Especially difficult was the levy of capital gain tax on commercial real estate and direct venture capital investment, such as participation in oil and gas exploration and high technology companies.

As you know, FIRPTA provides that existing multinational tax treaties be preempted after January 1, 1985. Our pension funds were stunned to learn that this legislation would presume to override existing treaties, which it would not even be possible to renegotiate by January 1, 1985 by most of the countries represented in our organization. We are also shocked by the possibility that capital gains could be taxed retroactively. This we feel is unacceptable. It was helpful to the U.S. capital market, then in a depressed state, when investors from Europe acquired property in 1974/75. For the resulting gains to be taxed on the basis of the 1980 legislation even, it is rumoured, without a step-up in basis, is considered grossly unfair and not in keeping with what we would expect from the U.S. Congress.

This and the uncertainty surrounding the whole FIRPTA statute has, without any doubt, seriously dampened our investment interest in U.S. commercial real estate, oil and gas exploration and high technology, and will continue to deter such investment unless this law is repealed or very substantially modified to reignite our interest. Reading through the FIRPTA reporting requirements and the ramifications thereof, even going to the extent of having to calculate the actuarial interest of certain beneficiaries in a pension fund, is sufficient to deter any medium-sized pension fund from investing in the U.S. especially when the fund realizes that such legislation apparently can be clamped on retroactively. It also gives a strong incentive to a fund holding only a limited interest to dispose thereof prior to January 1, 1985.

In any event, overseas pension funds being tax exempt in their own countries balk at being subjected to tax when investing in the U.S. They point out that the U.S. itself recognizes their U.S. pension funds as eligible for tax exemption on exactly the same grounds as their own exemption at home.

After the cold shower arising from FIRPTA at the end of the Carter Administration, the European pension funds considering further investments in the U.S. were greatly heartened by the introduction in Congress of various bills aimed at dealing with this matter. Whatever the final provisions of any legislation to be forthcoming, it shows the idea that bonafide non-profit pension plans ought not to be encumbered by U.S. barriers in their investment in the capital markets of the world is recognized by the legislators of the U.S. where, by far, the most important of these markets is situated.

We hope you will act promptly to modify this law by January 1, 1985. Meanwhile, it will be clear that although a repeal of FIRPTA will by no means deal with all the various problems bonafide foreign corporate pension funds encounter as far as taxation with regard to their U.S. investments is concerned, this will go some way toward alleviating these problems and will go a long way toward dealing with these problems as far as direct investments in commercial real estate, oil and gas exploration, and high technology are concerned.

It is emphasized that reducing barriers which prevent access to the U.S. capital market is a better way of encouraging such investments than maintaining high interest rates which, in the long run, will be both harmful to the U.S. economy and subject the U.S. to criticism in other parts of the world.

This view also seems to be underlined by the statement of Deputy Assistant Secretary Pearlman in his testimony before the House Ways and Means Committee on the first of May on H.R. 3025, a bill to repeal the 30 percent withholding on interest due overseas investors.

The Federation, therefore, strongly supports the initiative for the repeal of FIRPTA but would like to reiterate that it feels foreign non-profit corporate pension funds, in fact, ought to be exempt from all taxes on the same basis as U.S. corporate pension funds. I would ask to submit additional written views for the record of this hearing as an annex to my statement.

Senator WALLOP. Lord Howard.

STATEMENT OF THE LORD MARK FITZALAN HOWARD, LONDON, ENGLAND, ON BEHALF OF THE BRITISH ASSOCIATION OF INVESTMENT TRUST COMPANIES

Lord HOWARD. Mr. Chairman, my name is Mark Fitzalan Howard, and I am delighted to come from London to appear today on behalf of the Association of Investment Trust Companies in support of legislation to repeal FIRPTA.

The Association of Investment Trust Companies comprises about 180 investment companies with an aggregate portfolio value of around about $19 billion. About $6½ billion is invested in the United States. And a very significant part of those U.S. investments are in oil and gas explorations, in high technology companies and venture capital.

I would stress that we are long-term investors. We are not speculators. You will appreciate, therefore, Mr. Chairman, the surprise and, indeed, alarm when we realized that such investments may now qualify as U.S. real property holding companies under present FIRPTA regulations.

The effect, therefore, of first the tax implications and second the onerous reporting requirements of FIRPTA must inevitably and indeed tragically be to influence United Kingdom investment trusts not to provide valuable and much needed capital for funding such enterprises.

This cannot be in the national interest of the United States and its economy, especially at a time when we hear so much about your budget deficit. As you know, Mr. Chairman, FIRPTA became law in 1980. And I would guess that its hasty passage perhaps explains why its scope far exceeds its intent.

When FIRPTA was debated, both Houses of Congress clearly focused on real estate interests, with particular attention to agricultural real estate—a point, Mr. Chairman, you yourself have today very much emphasized. However, unfortunately, due to the definition published by your Internal Revenue Service, the scope of FIRPTA now far exceeds its original aim.

As a result, investment trust companies which never intended investing in companies whose main activities are holding for managing real estate now perversely find themselves ensnared by FIRPTA solely due to the quaint definition of what constitutes a U.S. real property holding company.

Surely now more than ever with all the troubles in the Middle East, the fundamental shortage of energy reserves, should the United States be encouraging, not frustrating, the inflow of capital to finance oil and gas exploration. And yet I submit unless FIRPTA is repealed, we foreign investors are very likely to cut back on such investment.

After all, under FIRPTA such oil and gas investments will have to perform significantly better than those in other countries so as to make good the tax imposed by FIRPTA. Furthermore, our concern extends also to investments in high technology and venture capital.

Again, because of FIRPTA's definition, such investments in such companies at times vital to your national defense and that of the free world will be threatened. Investment trusts are therefore bound increasingly to turn away from investing in technology in the United States and instead focus on other countries, such as Japan.

Finally, House and Senate conferees on Thursday, June 14, inflicted even greater injury by adopting withholding taxes due under FIRPTA—a move, Mr. Chairman, which I find inconsistent with the proposals currently being discussed to eliminate withholding tax from debt interests, a point again made by Senator Bentsen.

Thus, if FIRPTA is not repealed or amended before January 1, 1985, the date on which the statute overrides U.S. multinational treaties, there must be a grave risk that not only will it seriously discourage future investment in many U.S. companies, but that it will also encourage the sale of existing holdings now jeopardized by FIRPTA.

It is for these reasons, Mr. Chairman, we feel strongly that you will want to repeal FIRPTA.

Thank you very much.

Senator WALLOP. Thank you, Lord Howard.

[The prepared written statement of Lord Howard follows:]

ASSOCIATION OF INVESTMENT TRUST COMPANIES
OF THE UNITED KINGDOM

STATEMENT BEFORE U.S. SENATE COMMITTEE ON FINANCE

June 19, 1984

Hearings on S. 1915, a bill to repeal the
Foreign Investment in Real Property Tax Act

Mr. Chairman and Members of the Committee,

I, Mark Fitzalan Howard, Director, The Fleming Overseas Investment Trust PLC, am pleased to appear today on behalf of the Aassociation of Investment Trust Companies (AITC) in support of legislation (S. 1915) to repeal FIRPTA.

The Association respectfully submits, Mr. Chairman, that Congress in enacting FIRPTA has exceeded its intention to tax non-American acquisition of agricultural lands and has penalized instead not only many American companies eager to utilize international capital, but also its friends in the U.K. investment community as well. In addition, the barrier which FIRPTA imposes is inconsistent with current U.S. policy of encouraging the inflow of capital to reduce interest rate pressures and facilitate financing the U.S. deficit.

The AITC represents some 180 member firms, having approximately 34 percent of their assets or $6.5 billion invested in the U.S. at the close of last year. Traditionally a considerable proportion of our U.S. investments has been in oil and gas exploration, and more recently in high technology and venture capital companies. We have invested in many unquoted companies in these areas at early stages in their lives and in this way we have provided much needed capital for them. To avoid double taxation on their shareholders, U.K. investment trust companies (ITCs), along with other investors such as pension funds, are exempt from U.K. tax on capital gains realized within the fund and therefore have no U.K. tax liability against which to offset any liability to FIRPTA. The advent of FIRPTA has therefore meant that investments in such ventures which qualify as "real property holding companies" has become considerably less attractive to us not only because, unlike our other investments in the U.S., they are taxed on profits on their realisation, but also because of the onerous reporting requirements in connection with them. We submit that it is not in the national interest of the U.S. that it should be deprived of valuable capital for such enterprises because of the existence of FIRPTA. In any case, although not having precise knowledge, we very much doubt if FIRPTA would yield significant revenues.

The U.K. investment trust movement, with assets of around £19 billion, is one of the largest collective investment institution of its kind in Europe investing in equities. The U.K. ITCs have been in existence for over 100 years and this method of spreading the risks of equity investment throughout the world is greatly valued by private and institutional shareholders alike. ITCs have always had a substantial proportion of their total assets in U.S. securities held as long-term portfolio investments; they are not short-term opportunistic investors. There are approximately 650,000 shareholdings in companies within the movement of whom 85 percent by number are private investors and 15 percent are institutional, the latter in turn representing ultimately a further vast number of private individuals who are indirect investors in investment trusts through unit trusts, insurance companies or pension funds, etc. This Association is therefore concerned that the millions of private individuals invested directly or indirectly in investment trust companies should not be harmed by FIRPTA, even if unintentionally.

The U.K. ITCs are not trusts in the legal sense but are joint stock companies incorporated with limited liability under the Companies Acts, and having a full listing on the U.K. Stock Exchange. They are closed-end funds formed for the collective investment in shares and securities of monies subscribed as share and loan capital by their members and loan stockholders. Their assets are widely spread among a large number of companies, the average investment usually representing less than one percent of the ITC's assets normally being in the nature of passive portfolio investments rather than active direct investments. Only occassionally would an investment exceed five percent of the ITCs assets.

Responsibility for running an ITC lies with its Board of Directors, but most now have a relationship with a manager - an individual, partnership, investment management company or the investment management department of a merchant bank - who deals with administration and investment management following the broad objectives set by the Board.

The investor in an investment trust company buys not the underlying assets, but shares in the commpany that owns them. Private shareholders obtain professional portfolio management and a spread of risk which would generally not be possible from a direct portfolio of their own. Institutional shareholders get the benefit of buying an interest in a ready-made equity portfolio.

The investment policy of an ITC depends on its general objective. Most are general funds, but many concentrate on particular geographical areas such as North America or particular industries such as energy or technology. Some seek to maximize long-term capital growth; some aim for high income.

As ITCs are closed-end companies, their funds available for investment cannot be reduced by redemptions on demand by their shareholders. They can, therefore, take a longer term view of investment opportunities. Their structure is thus ideal for investment in unlisted developing companies and venture capital projects, where the potential returns can reflect the risk if the investor is able to wait for them to mature.

As you know, FIRPTA became law at the close of 1980 and one would surmise that its hasty passage explains why its scope exceeds its intent. The debate which occurred on the floors of both houses of the Congress clearly focused on real estate investments. Indeed it can be fairly stated that the recurring emphasis during Senate and House consideration of the legislation was to tax the gains realized by non-resident on sale or disposition of U.S. real property as well as gains realized from the sale or exchange of an interest in a corporation, trust, or partnership formed to hold U.S. real property interests. Unfortunately, because of the definition published by your Internal Revenue Service (IRS) in the various draft regulations, the scope of the legislation has gone far beyond this simple aim.

AITC member companies do not invest heavily in companies having as their primary business activity the holding or management of real estate. However, they become subject to FIRPTA's onerous requirements by virtue only of investments in companies having certain business assets which meet the law's definition of a "U.S. real property holding company."

In view of the troubled situation in the Middle East, and the fundamental shortage of domestic energy reserves it seems that the U.S. should now more than ever remove any impediment to domestic oil and gas exploration capital. The AITC submits that, unless the effects of FIRPTA are removed, the result will be materially to reduce the finance from outside the U.S. for oil and gas exploration. If FIRPTA takes effect, our investments in oil and gas companies will have to perform significantly better than those in any other country in order to compensate for the tax imposed by FIRPTA for which there is no U.K. relief available to ITC's shareholders.

FIRPTA similarly jeopardizes our investment in high technology and other venture capital companies in the U.S. These companies, I believe, are regarded in America as a vital part of your national defense and that of the free world. Furthermore, they should achieve above average growth to the benefit of the U.S. economy. Because of FIRPTA, ITCs may increasingly turnaway from investing in technology in the U.S. and focus on other areas such as Japan.

In addition, current FIRPTA proposals impose a totally impractical reporting procedure on the U.S. companies within its scope and on their overseas investors. The alternative of withholding poses equally intractable problems.

Many U.S. companies which are not primarily engaged in the real estate business have real property in the course of their normal business and thus fall within the purview of FIRPTA. As a consequence, non-American investors such as ITCs will be subject to unacceptably onerous requirements such as: (1) reporting to their thousands of shareholders their holdings in FIRPTA companies, even if only on a see-through basis; (2) the threat of criminal penalties for failure to file with your Internal Revenue Service (IRS) information only available from

U.S. firms over which they have no control; (3) requiring their shareholders to file returns with your IRS of their U.S. property interests held indirectly through the ITCs; (4) restricting the use of precious capital pledged to the IRS under security agreements which diverts funds otherwise available for investment.

In addition, the valuation of assets held by oil and gas exploration and high technology companies is simply not practical when compared to real estate. How can the value of shares in companies having "non-business" assets, yet deemed under FIRPTA to be "real property holding companies", be precisely valued so that the tax liability on the gain can be determined? What is the precise value of a partially proven oil or gas reserve and what is the value of a high technology company's patent rights and R & D know-how? Yet these valuations are critical in determining whether or not the company is within the scope of FIRPTA.

Set out below are just three examples received from our member companies where FIRPTA is already affecting their investment decisions.

(A) One group manages several oil and gas companies which are resident in the U.S. for tax purposes but are owned by U.K. resident bodies. It had arranged to transfer the residence of these funds into the U.K. at this relatively early state in their life without material U.S. taxation in order to avoid the double tax effects of FIRPTA. In view of the possiblity of the repeal of FIRPTA it has not yet transferred the residence of these companies. If FIRPTA is not repealed it will complete these transfers, with the consequent loss to the federal and state taxing authorities of revenue in the future. It is actively looking to expand this side of its business and any future companies formed will, unless FIRPTA is repealed, also be resident in the U.K.

(B) A member invests in high technology companies, mainly outside the U.K. Some of these companies in the U.S. may unexpectedly be caught within the FIRPTA net. The member as a matter of policy now normally refuses opportunities to invest in any such company which may be treated as a U.S. real property holding company.

(C) One group has indicated that, if FIRPTA remains in its present form, it would have to seriously consider disposing of its holdings in companies within the FIRPTA net before the reporting requirements come into effect.

Mr. Chairman, the Senate version of the 1984 tax bill (H.R. 2163) proposes to phase out the current 30 percent withholding tax applicable to interest payments due to non-American investors. Hearings occurred on May 1 in the House Ways and Means Committee on H.R. 3025 to repeal the 30 percent withholding tax. The Senate rationale for the end to this tax, supported by the U.S. Treasury in House hearings, rests on the need to remove American impediment to foreign investment. We submit that retaining FIRPTA as currently written is inconsistent with present U.S. Senate and Administration thinking. We also note the recent introduction of H.R. 5673 (for repeal of FIRPTA) in the House of Representatives by senior Members of the House Ways and Means Committee, several of whom also co-sponsored H.R. 3025.

Congress exempted capital gains on foreign investors in 1936, basing its action on the following reasons:

> "Such a nonresident alien will not be subject to the tax on capital gains...as at present, it having been found administratively impossible effectually to collect this latter tax. It is believed this exemption from tax will result in considerable additional revenue...from the income tax in the case of persons carrying on the brokerage business."

The above text was taken from Senate Report 2156, 2nd Congress, 2nd Session (1936).

Indeed, the encouragment of foreign investment is also a matter of public policy at the state level. Many states are actively seeking non-American investment through trade missions, advertising, tax incentives, etc. Hardly a year goes by without one of your Governors visiting capitols abroad to seek non-American capital.

Finally, FIRPTA contains provisions which, in our view, add international insult to statutory injury: it conflicts with the current U.K./U.S. double tax treaty which provides that U.S. enterprises wholly or partly, directly or indirectly, owned or controlled by one or more residents of the U.K. shall not be subject to any tax-related requirements which are more burdensome than those which are imposed on U.S. residents. We believe that the reporting provisions of FIRPTA and its associated regulations impose a far greater burden on those U.S. enterprises, with "U.S. real property interests," which have U.K. ITC investors compared to similar U.S. entities with only local investors.

Indeed, the basis for relief seems even more compelling in view of the U.S. Department of Agriculture reports of the past two years wherein it is stated that: (a) non-American ownership of U.S. farm land amounts to only one and one-half percent of all such land, and (b) the rate of increase in non-American land ownership was less in the past annual reporting period than at any other time since the Department began compiling and reporting the data in 1979.

Therefore, Mr. Chairman, we urge your prompt consideration of our request that repeal of what we regard as this monster called FIRPTA be granted before this Congress adjourns.

Senator WALLOP. I wonder if just for the record if you could encapsulate some of the onerous reporting requirements to which you referred in your testimony.

Lord HOWARD. Yes, Mr. Chairman. When an investor is deemed to be a substantial investor—that is, that he has 50,000 dollars' worth of investment, there is a requirement to report the disposal of shares of real estate and there is the considerable problem that we have in the see-through in order to arrive at that $50,000. In other words, there is a tier of investments which can lead to reporting requirements which many investors will simply not be cognizant of.

Senator WALLOP. This would be investors in one of your investment trust companies? Individually as well as the trust company?

Lord HOWARD. That is correct, Mr. Chairman.

Senator WALLOP. Is that the same with the retirement and pension funds, Senator Van Tets?

Senator VAN TETS. Yes. It would even extend to pension funds, and we would have to calculate the actuarial interest of certain of the larger beneficiaries of the pension funds.

Senator WALLOP. Individually as opposed to the pension itself.

Senator VAN TETS. That's what the American lawyers told us.

Senator WALLOP. That's a long way from where we were.

I wonder if you could describe how it gets into your investment in high technology or venture capital because clearly that's a long way from agricultural real estate.

Lord HOWARD. Mr. Chairman, this arises because of the definition of what constitutes a U.S. real property holding company. Only certain assets are included on which to draw the criterion as to whether or not 50 percent of the company's assets are deemed to be in real estate. The result is that a company which can raise money and have a property investment which is simply an ancillary and not its main business, for the purpose of computing whether or not at any one point in time that company has more than 50 percent in what is deemed to be U.S. real property interests can lead to companies being classified as real property holding companies when that is not their intent.

I think, Mr. Chairman, and I hope you would agree with me, that a property company to an investor is essentially one where an investor goes in in order to look for enhancement of real estate values. The FIRPTA regulations as currently delineated would suggest that this will embrace many venture capital oil and gas investments which I am sure one never intended to be within the FIRPTA scope.

Senator WALLOP. So that by acquiring oil and gas properties—supposing those aren't real properties but simply leases? Do they qualify under FIRPTA as real property holdings?

Lord HOWARD. I would not be able to tell you the exact scope as to whether leases are included or not.

Senator WALLOP. I see Mr. Knight is nodding his head.

Mr. KNIGHT. Mr. Chairman, it's my understanding that interests in U.S. oil and gas properties held by foreign investors clearly would be subject to FIRPTA, treated as U.S. real property.

Senator WALLOP. That's an astonishing distortion.

Mr. KNIGHT. The definition of real property also includes draft farm animals used by a foreign investor in connection with a U.S. farm.

Senator WALLOP. That I know is not in the bill.

Mr. KNIGHT. It's in the regulations. Even if the reporting requirements under FIRPTA are repealed it will be necessary for a foreign investor who owns an equity interest in a privately—held U.S. company and later sells that interest to provide to the IRS, under complicated FIRPTA valuation rules and formulas, that the company was not a U.S. real property holding corporation. Otherwise, the foreign investor's gain on the sale will be subject to the FIRPTA tax.

Senator VAN TETS. The mere effect, Mr. Chairman, of there being this burden of having to go into that sort of thing on the basis of American regulations in itself is a deterrent there are a lot of pension funds that couldn't or would want to cope with that. They will say let's pass; let's go somewhere else.

Senator WALLOP. Well, I can understand why that would be. What I can't understand is how anybody can draw the dimension that a lease to develop a mineral can be construed in any way as a real property. It is a property, but to my knowledge in no other area of tax law—correct me if I am wrong—is it considered real. I mean it's varitable but not real in the terms that we use it with relation to real estate.

But I appreciate your long journey to give short testimony, but I think it has been valuable to the committee in terms of trying to assess some of the effects of this legislation as it has been implemented.

Thank you both very much.

Senator WALLOP. We have one last witness. That is Mr. Brian Dooley, director of Dooley & Associates, Newport Beach, CA.

STATEMENT OF HELEN K. DOOLEY, BRIAN G. DOOLEY & ASSOCIATES, NEWPORT BEACH, CA

Ms. DOOLEY. I'm not Mr. Dooley. I'm Helen Kathleen Dooley substituting at the last minute.

Senator WALLOP. You don't look like Brian. But I have seen several things since I have been in Congress that would fool me.

Ms. DOOLEY. Let me introduce myself. I am Kathleen Dooley, a Washington, DC, attorney speaking on behalf of my brother, Brian Dooley, a CPA in Newport Beach, CA. He regrets that at the last minute he had a business emergency that didn't allow him to attend, and asked me to speak on his behalf.

I might add that in addition to being an attorney, I have some experience in commercial law, a little bit of knowledge of tax. Not the level of your other experts. But I was also an assistant to the Administrator of the Agricultural Marketing Service at USDA until 1979, so I am not totally ignorant of some of the issues.

We are in favor of total repeal of FIRPTA. And we have three primary reasons. One is to ease the economic pressures that have been placed on the U.S. farmer. Two is to remove from the Internal Revenue Code provisions which restrict the free flow of capital into the United States. And the third is to remove from the Internal

Revenue Code a provision which has already become redundant since the passage of section 338 and pending legislation found in the Senate deficit reduction tax bill of 1984, and in H.R. 4170, focusing on the issue of the farmer.

Although FIRPTA originated from a fear that OPEC investors were buying up U.S. farmland and obtained such high prices that the American farmers could not compete, the passing of the act has brought little relief to the plight of the American farmer. Since the passage of FIRPTA, there has been a steady decline in the standard of living of the American farmer. The value of farmland has decreased from approximately $826 billion in 1981 to $770 billion in 1983, a decline of $56 billion.

In addition, while the farmers' net cash farm and nonfarm income has remained fairly consistent since 1979, the amount of the net cash flow for farm loans has greatly diminished from approximately $26 billion to approximately $8 billion in 1983. Because of this, there has been a reduction in personal consumption of approximately $56 billion in 1979 to $52 billion in 1983, showing a $14 billion decrease.

Restrictions on the flow of free capital. I think that your other witnesses have really dealt with this, but let me just articulate three of the concerns that we have. There are a variety of means by which a nation imposed exchange control. Most nations have historically imposed exchange controls to prevent the flight of capital. However, FIRPTA has unintentionally created an exchange control preventing the flow of money into the United States.

We find three primary reasons for this. Onerous disclosure requirements required by the act for a purchaser of real property; the taxable income at the time of sale; and the uncertainty of the American law changes with respect to the foreign investor.

Take for example this: In 1970, the foreign investor had a choice of investing in U.S. stock or security or depositing his funds in a U.S. financial institution or investing in U.S. real estate. All three of these investments would have given the foreign investor a return free of U.S. income taxes. If the foreign investor had acquired stock or securities, he would have been allowed to sell them tax free in 1980. If the foreign investor wishes to withdraw his interest income from his financial institutions, he would have been allowed to do so in 1980.

However, if the foreign investor wished to sell his real property free of U.S. income taxes, he no longer could do that. Focusing on the redundant provisions of the act, the tax equity [TEFRA] enacted in 1982 enacted special rules for regards to the distributions of appreciated property and redemption of stock in certain purchases treated as asset purchases.

These provisions, along with the provisions now pending in the Senate debt reduction tax bill of 1984, and the House tax reform bill of 1984, H.R. 4170, provide additional rules with regards to the distribution of appreciated property by corporations. These provisions will accomplish much of the same results as section 897 in FIRPTA.

Under the new provisions gains but not losses would generally be recognized to distribution corporations on any ordinary nonliquidating distribution whether or not it qualified as a dividend or property. The gain will be recognized if such property has been sold to the distributing corporation from its market value.

TEFRA amended Internal Revenue Code section 311(d) and created section 338. As a result, the distribution of appreciated property by a corporation, either a nonliquidating distribution or as part of the purchase of the corporate stock of a corporate asset, is a taxable event to the transferring corporation.

It should be noted that much of the revenue raising measures of FIRPTA can be obtained by the above positions.

In summary, I would like to describe my brother's CPA practice. It's not a large one. It doesn't have extremely large clients. It has a large number of smaller foreign investors. And when they come to him to talk to him about investing in U.S. real estate, he has to be very discouraging. He has to tell them that it would cost them $20,000 or more over a period of 5 years just to hire his services in terms of reporting and taking care of the reporting and other tax advice that they would need in order to do that.

Most of them have been discouraged and a lot of them are taking their business to Australia. So I think in that sense that the U.S. Government is losing a lot of foreign money that it really needs to have here.

Thank you very much.

Senator WALLOP. Thank you, Ms. Dooley.

[The prepared statement of Ms. Dooley follows:]

Brian G. Dooley
and Associates

Director
Brian G. Dooley, C.P.A.

5140 Birch St. Second Floor
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June 14, 1984

The Honorable Senator Robert Dole
U.S. Senate Committee on Finance
Dirksen Senate Office Building
1st & C Street - North East
Washington, D.C. 20510

Dear Honorable Chairman:

The passage of S.1915 which would repeal the Foreign Investment Real Property Tax Act would ease the economic pressures that have been placed on U.S. farmers, remove from the Internal Revenue Code provisions that restrict the free flow of capital into the United States, and remove from the Internal Revenue Code a provision that has become redundent due to the passage of Section 338 and the pending legislation found in both the Senate Deficit Reduction Tax Bill of 1984 and the House of Representatives Tax Reform Bill of 1984 (HR 4170) relating to distribution of appreciated property by corporations (Section 36 of the Debt Reduction Tax Bill of 1984 and Section 311(d) of the Internal Revenue Code).

HARDSHIP OF U.S. FARMERS

Last Thursday's edition of the "Wall Street Journal" had the following headline **"Farmland Prices Sink Further and Might Not Recover for Years".**

Ironically the Foreign Investment Real Property Tax Act (hereinafter referred to as "FIRPTA") originated because of the farmer's concern that investors from the OPEC countries and other foreign investors were buying up all the United States farmland and paying such high prices, that U.S. farmers were unable to compete for agricultural property.

I believe as did the Honorable Congressman Conable[1] that the increase in value of farmland benefits the American farmer.

As the following statistics will show, all the farmers would have been better off with more valuable farmland. History has shown that even with the reduction of value of farm property, the size of the average farm has not substantially increased.[2]

I would like to regress back to October 25, 1979 and the Hearings before the Committee on Ways and Means of the House of Representatives with regards to the legislative proposals to deal with the taxation of foreign investors on the direct or indirect ownership of property in the United States. During the Hearing the witnesses who were proponents of the Bill were primarily from and representing the farm communities. As I mentioned, the Honorable Representative Conable presented the view that the increase in the value of farmland was a benefit to the farmer since their financial strength was enhanced by the increased value of the property since this would increase their borrowing power and allow them to expand their farm operations if they wished to do so.[3]

Since the passage of FIRPTA there has been a steady decline in the standard of living of the American farmer. I note the following statistics:

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[1] During the October 25, 1979 Hearing before the Committee on Ways and Means of the House of Representatives, the Honorable Congressman Conable makes the following statement to the Honorable Senator Wallop: "A farmer wants to expand and the price of land is going up. It is a problem. Inflation is a problem for everbody. But down my way, everybody is a dairy farmer and they are seriously limited in the number of cattle they can buy by their borrowing power, and if the land is worth more, they can borrow more, and if they can borrow more, they can put on more cows." - See page 42 of the Hearing Report.

[2] The average farm has increased by 8 acres from 429 acres in 1980 to 437 acres in 1983. See Schedule 1141 of the "Statistical Abstract of the United States 1984, U.S. Department of Commerce 114th Edition, Section 24 - Agriculture, hereinafter referred to as the "1984 Agricultural Report."

[3] I assume that the Honorable Representative Conable had in mind the debt to asset ratio of the farmers.

At the end of 1979 there were approximately $1.043 Billion land acres in farming. Preliminary estimates as at the end of 1983 there were approximately 1.035 Billion land acres in farming.[4]

Since FIRPTA the value of farmland has decreased by $56 Billion from $826.1 Billion Dollars in 1981 to $770.3 Billion Dollars in 1983.[5]

At the end of 1979 the total farm debt was $140.8 Billion Dollars. As of the end of 1983 the total farm debt is estimated at $216.3 Billion Dollars. Further the debt to asset ratio as a percent has increased from 16.1% in 1979 to 20.6% at the end of 1983.[6] (The higher percentage, the weaker financially the farmer becomes.)

Eventhough the farmers net cash farm and non-farm income has remained fairly consistent since 1979,[7] the amount of net cash flow from farm loans has greatly diminished from $26.6 Billion Dollars in 1979 to only $8.3 Billion Dollars in 1983. (This is more than a 68% decline in the availability of borrowed funds.)

Because of this the U.S. farmers have had to reduce their personal consumption from $66.3 Billion Dollars in 1979 to $52.1 Billion Dollars in 1983.[8] This is true eventhough the net income from farm operations has increased since 1981 from $21.5 Billion Dollars to $22.1 Billion Dollars in 1982.[9]

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[4] Text Schedule 1141 of the 1984 Agriculture Report.

[5] Schedule 1155 of the 1984 Agriculture Report.

[6] Schedule 1159 of the 1984 Agriculture Report.

[7] Schedule 1161 of the 1984 Agriculture Report shows net cash farm and non-farm income for 1979 as $78.2 Billion Dollars and for 1983 $77.1 Billion Dollars.

[8] Schedule 1161 of the 1984 Agriculture Report.

[9] Schedule 1163 of the 1984 Agriculture Report.

Because of this decline, the Commodity Credit Corporation (a wholly government-owned corporation established by Congress in 1933) has increased the amount of loans made to farmers from $4.576 Billion in 1979 to $11.454 Billion in 1982.[10] I believe that a Seven Billion Dollar increase in loans is a lot of money. I note that the Reagan Administration in the Administration's Revenue Provision and 1985 budget estimates that the amount of revenue from FIRPTA withholding will be $80 Million Dollars for fiscal year 1985, $8 Million Dollars for fiscal year 1986, and $9 Million Dollars for fiscal year 1987. This revenue increase is quite small by comparison to the annual $7 Billion loan increase.

In summary, FIRPTA has been a very expensive provision. While all of the decline in the farm sector cannot be blamed upon the lack of foreign investment due to FIRPTA, most of us recall from our basic economic studies the affect upon a decrease in demand in the application of the supply and demand theory. It is not a coincidence that the farmer's plight began shortly after the introduction of FIRPTA. This is true eventhough interest rates have declined dramatically since 1980.

FIRPTA RESTRICTS THE FREE FLOW OF CAPITAL

There are a variety of means in which a nation imposes exchange control. Most nations have historically imposed exchange control to prevent the flight of capital. However, I believe FIRPTA has unintentionally created exchange control preventing the flow of money moving into the Country.

Ironically, the unintentional restriction on foreign investment in United States real property comes at the time that the Trade Deficit expands sharply. In April the trade deficit expanded 19% to a seasonally adjusted $12.19 Billion Dollars. The "Wall Street Journal" reports that the 1984 Trade Deficit could be more than double the record 1983 Trade Deficit of $69.39 Billion Dollars.[11]

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[10] See Schedule 1174 of the 1984 Agriculture Report.

[11] "Wall Street Journal", May 31, 1984.

Despite the outflow of U.S. dollars from the trade deficit, foreign investment in Unites States real property interest dropped in 1982 by 37.8% to only $2.33 Billion Dollars.[12]

There is only one commodity which Americans can sell to the foreign investor that the foreign investor can never take with him and remove from our Country. This commodity is real estate. The more the foreign investor has at stake in our Country the less the foreign investor is willing to impose or cartel upon the United States and diminish the value of his investment. During the pre-FIRPTA Hearings there was great concern about the OPEC members buying up America. History has shown us how silly it is to believe that a cartel can defeat the natural rules of supply and demand. How silly it must be to really imagine a foreign nation not wanting to maximize its return on its massive foreign investment. Can one really imagine foreign investor's placing billions of dollars into real estate to allow the land to sit idle.

FIRPTA by requiring harsh and discriminatory tax treatment has made the investment in the United States property less attractive to the foreign investor.

Many foreign investor's feel as though they were double-crossed by the United States Government. Take for example the foreign investor who in 1970 invests his capital into U.S. real estate. At the time of the investment the foreign investor would have had the choice of investing in U.S. stocks or securities, depositing his funds with a U.S. financial institution, or investing in U.S. real estate. All three of these investments would have given the foreign investor a return free of U.S. income taxes.[13]

If the foreign investor had acquired stocks or securities, he would have been allowed to sell them tax free in 1980. If the foreign investor wished to withdraw his interest income from his financial institution deposits he would have been allowed to do so, tax free. However, if in 1980 the foreign investor wished to sell his real property free of U.S. income tax, he would no longer be allowed to do so. I don't think its hard to understand why many foreign investors investing in U.S. real estate feel double-crossed.

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[12] The "Wall Street Journal" dated June 2, 1983 citing the U.S. Commerce Department Annual Report.

[13] Of course the foreign investor may be required to pay income tax where he is a resident.

TAX LAWS SHOULD HAVE A NEUTRAL EFFECT ON INVESTMENT DECISIONS

Because of the disparity mentioned above, the tax laws are not having the neutral effect upon business and investment decisions which they should have. To the foreign investor there are several tax advantages of investing in stocks and securities or deposits in financial institutions over investing in U.S. real estate. FIRPTA, unintentionally, has distorted the investment attitudes of the foreign investor. This has occurred in a time in which there is much discussion on making tax laws "neutral" with respect to business and investment decisions.

Here the effect is overwhelming. The foreign investor who does not wish to disclose his investment holdings in the United States will invest in either U.S. stocks or securities or deposits in financial institutions. The foreign investor who wishes a tax free return will invest either in U.S. stocks or securities or financial institutions. This distortion will increase of course, if the pending bills with regards to the removal of U.S. withholding on interest and dividends is passed (and especially if FIRPTA is amended to require U.S. withholding from the sale of U.S. real estate).

The disincentive to invest in U.S. real estate may not push the foreign investor towards U.S. stocks or securities or towards deposits with financial institutions.

However, many foreign investors are extremely conservative and do not wish to invest their money in financial or commercial activities during such uncertain times. Those foreign investors who wish to remain owners of real estate will compare the rules of the United States with the rules to the other Western nations. Many of those foreign investors will be investing in those jurisdictions which do not have FIRPTA type legislation.

FIRPTA PROVISIONS ARE REDUNDENT

The Tax Equity and Fiscal Responsibility Bill of 1982 (TEFRA) enacted special rules[14] with regards to distributions of appreciated property and redemption of stock and certain stock purchases treated as asset purchases. These provisions along with the provisions now pending in the Senate Debt Reduction Tax Bill of 1984 and the House of Representatives Tax Reform Bill of 1984 (HR 4170) provide additional rules with regards to the distribution of appreciated property by corporations. These provisions will accomplish much of the same result as Section 897 (the Income Tax Provision for FIRPTA). Thus, many of the income tax goals of FIRPTA will be accomplished through these new provisions.

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[14] Sections 222 through Section 224 of TEFRA.

Under the new provisions gain, but not loss, will generally be recognized to distributing corporations on any ordinary, nonliquidating distribution whether or not it qualifies as a dividend ofr property. The gain will be recognized as if such property had been sold by the distributing corporation for its fair market value.[15]

The TEFRA provisions amended Internal Revenue Code Section 311(d) and created Section 338. As a result of TEFRA the distribution of appreciated property by a corporation as either a nonliquidating distribution or as part of a purchase of the corporate stock or corporate assets is a taxable event to the transferring corporation.

Accordingly, much of the revenue raising measures of FIRPTA can be found in the Internal Revenue Code or in provisions that are about to be added to the Internal Revenue Code.

FIRPTA PROVISIONS ARE IN CONFLICT WITH OTHER PROPOSED LEGISLATION

Section 142 of the Senate Deficit Reduction Tax Bill of 1984 would repeal the 30% withholding tax on certain interests paid to foreign persons who loan money to U.S. borrowers.

It is not hard to recognize the inconsistencies between FIRPTA (especially a FIRPTA which requires withholding) and Section 142 of the Deficit Reduction Tax Bill of 1984. If the goal is to encourage the inflow of foreign capital into the Country, FIRPTA should be repealed.

Is it not better to have the foreign investor as an equity investor versus a lender? As a lender the foreign investor can demand repayment when the loan is due.[16]

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[15] See page 177 of the Explanation of the Senate Finance Committee issued April 2, 1984 regarding the Deficit Reduction Tax Bill of 1984.

[16] This is true even if the borrower is a country (Argentina, Brazil, Mexico, etc.).

An equity investment has no due date for repayment. The foreign investor who makes an equity investment in the United States is casting his economic vote in favor of the United States Government. He is the long term investor in America.

The existence of FIRPTA contradicts the intent of Section 142.

UNDER FIRPTA FOREIGN INVESTORS ARE TAXED ON GAINS BUT RECEIVE NO BENEFITS FOR DEPRECIATION OR LOSSES

FIRPTA is specifically designed for the nonresident alien or foreign corporation not engaged in a U.S. trade or business.

Consequently, the foreign investor receives no tax advantage from depreciation while the U.S. investor receives the tax advantage of the rapid ACRS depreciation.

A foreign investor receives no tax advantage during the period of time in which the real estate investment produces a negative cash flow.

The foreign investor receives no tax benefit if the property is sold for a loss; while the U.S. investor receives an ordinary loss treatment even if the asset should be considered a capital asset in economic terms.[17]

As I mentioned, FIRPTA is specifically designed for those foreign investors who have no U.S. source trade or business income.

All the lucrative "up-front" deductions that make real estate an attractive investment for U.S. taxpayers, provide no tax benefit at all for the foreign investor who falls under FIRPTA.

It seems fair that the FIRPTA foreign investor would not be required to pay tax on a gain when the real property is sold since he received no tax benefit during the period of ownership of the real property. Additionally, if the property should decline in value, he receives no tax benefit for his loss.

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[17] The Internal Revenue Code considers the ownership of rental property as a trade or business eventhough most of us consider it an investment.

In the May 1979 Department of Treasury Report on the **Taxation of Foreign Investment in U.S. Real Estate** this issue was addressed. The author of the report discusses an elaborate partnership arrangement between a foreign investor and a U.S. taxpayer in which the tax benefits which the foreign investor is unable to use are assigned to the U.S. taxpayer.

My experience is that foreign investors rarely desire to enter into partnerships with U.S. persons.

However, if an elaborate partnership structure as discussed in the Treasury Report is entered into under today's tax law, the U.S. taxpayer would discover that the provisions that allowed an uneconomic assignment of tax benefits have been eliminated through tax reform, new regulations, and court cases and pending legislation.[18]

IS FIRPTA A REVENUE LOOSER?

Ignoring for a minute the additional $7 Billion Dollars loaned indirectly by the United States Government to the farmers since the enactment of FIRPTA,[19] the Committee should examine the net profit to the United States Treasury by FIRPTA.

The administration's revenue provision for the 1985 budget report estimates that for fiscals years 1986 and 1987 $8 Million and $9 Million, respectively will be collected if the withholding is added to FIRPTA.

I submit that if the Committee were to subtract the cost of administration of FIRPTA then the Committee would discover that the net revenue from FIRPTA may not cover the cost of administration.

I believe that if the Committee were to compare the net revenue from FIRPTA to the effects which FIRPTA has on the free flow of capital that the Committee would conclude that FIRPTA is a financial looser.

Thank you very much Mr. Chairman for the opportunity to present my views.

Very truly yours,

BRIAN G. DOOLEY,
Certified Public Accountant

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[18] Section 71 to 79 of the Tax Reform Bill of 1984 - H.R. 4170 and Section 55 to 61 of the Senate's Deficit Reduction Tax Bill of 1984.

[19] If the repeal of FIRPTA would improve the economic condition of U.S. farmers so that the loans from the Government declineed by only 1/10 of 1 percent, the repeal would reduce the amount of loans by $11 Million Dollars at a revenue cost of $8 - $9 Million Dollars.

Senator WALLOP. I understand what you say. I think it's fair to say that while FIRPTA was not a cure for the ails of the farming economy nor was it intended to be, neither is it accountable for all the ails that presently exist in the farm economy. I will not shoulder that burden, whatever other one I pick up today because that would be acting primarily in my own worse interest. And I, like many others in this world, do have an overriding enlightenment when it comes to self-interest.

But I do hear and have heard what has been said today. I think it would be interesting from the standpoint of the record if we could have the oil and gas industry through the representation of IPAA and the American Petroleum Institute weigh in with regard to their understanding of how this is diminishing their exploration opportunities. And I would hope that we would get farm groups to assess this as well.

Should it be that they have the same understanding as has been expressed here, that would go a long ways toward adding a tremendous incentive for Congress to act and in this session. I hear what you say about deadlines. They alarm me as much as they alarm you. I also have been around here long enough to know that the only thing we have ever done in a hurry practically speaking was to authorize television of Redskins' football games. [Laughter.]

That appears to be a matter of overriding national concern when the Senators couldn't get seats any longer. [Laughter.]

But it is possible from time to time that we act in other ways. So I appreciate your testifying on behalf of your brother.

Ms. DOOLEY. Thank you very much, sir. And we appreciate your reexamining the issue.

Senator WALLOP. I thought that's what we had been doing here this morning.

I thank everyone. The witness list having been exhausted and Senators also being exhausted from other reasons, we will call this subcommittee adjourned.

[Whereupon, at 11:35 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

SUBMITTED FOR THE RECORD
June 19, 1984

Record Copy

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
SUBMITTED TO THE
U.S. SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 1915, which would repeal the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), relating to the taxation of gains derived by foreign persons from the disposition of interests in United States real property. For the reasons discussed below, the Treasury Department believes that the taxation of gains realized by foreign persons from the disposition of U.S. real estate represents sound tax policy. We therefore oppose the repeal of FIRPTA.

The Internal Revenue Code imposes different regimens of taxation with respect to U.S. persons, i.e. citizens, residents and domestic corporations, and foreign persons, i.e. nonresident aliens and foreign corporations. In general, U.S. persons are subject to taxation on their worldwide income on a net basis (net of deductions) and at progressive rates while foreign persons are subject to U.S. taxation on a more limited basis. More specifically, foreign persons are generally subject to U.S. taxation on a gross basis (without deductions) on fixed or determinable annual or periodical gains, profits and income ("fixed or determinable income") from U.S. sources at a rate of 30 percent. Fixed or determinable income includes interest, dividends, rents, royalties and similar types of income but ordinarily does not include gain realized on the sale of a capital asset such as real property. U.S. taxes on fixed or determinable income of foreign persons are enforced by requiring the payor of the income to withhold the appropriate tax from the amount of the payment. Foreign persons are also subject to U.S. taxation on a net basis on income effectively connected with the conduct of a U.S. trade or business at rates and in a manner comparable to that applicable to a U.S. person. These regimens of taxation may be modified by the application of a bilateral income tax convention.

Most investments by foreign investors in income producing U.S. real property either constitute a U.S. trade or business or are taxed at the election of the foreign investors as if they constitute such a U.S. trade or business. Thus, foreign persons generally are taxed on income derived from these investments on a net basis and can take advantage of the depreciation, mortgage interest and other deductions related to real property ownership provided by the U.S. tax law during the time that they own real property. Ordinarily, such treatment of real property ownership as effectively connected with the conduct of a U.S. trade or business would require that the foreign investor recognize and pay tax on any gain derived when the property is sold. Nevertheless, under pre-FIRPTA law it was readily possible for a well advised foreign investor to avoid tax on capital gains realized from a disposition of his interest in U.S. real property, even if that property had been used by the foreign person in a U.S. trade or business.

A report prepared by the Treasury Department and submitted to Congress on May 4, 1979, described a number of means that were commonly used by foreign investors prior to the enactment of FIRPTA to avoid United States tax on such gains. Included among these tax planning devices were:

> (i) An installment sale of the property with the bulk of the payment being received in years after the cessation of the U.S. taxpayer's conduct of a U.S. trade or business. Because the foreign person had no active trade or business when the payments were received, they were not subject to U.S. tax.
>
> (ii) The sale of stock in a holding company that owned the property rather than sale of the property itself. Mere ownership of stock does not ordinarily constitute the conduct of a trade or business under U.S. tax rules so that the gain derived from the sale of the stock would not be effectively connected with the conduct of a trade or business by the taxpayer and would therefore not be taxed in the United States. Subsequent liquidation of the holding company by the purchaser could often be accomplished at only a modest tax cost.

(iii) The sale of property by a holding company followed immediately by a section 337 liquidation of that holding company and the distribution of the sale proceeds to the foreign shareholder. This approach would result in no gain being recognized by the liquidating corporation because of the application of the provisions of section 337. Since, as indicated above, the foreign person's stock ownership did not constitute a U.S. trade or business, and since under U.S. tax rules the corporation's stockholder would be treated as if he had sold his stock rather than the underlying real property, the foreign person would not be taxed on the transaction.

While each of the alternatives for avoiding tax was not available or appropriate in every situation, the number of available alternatives made it possible for foreign investors to avoid tax on most gains realized on disposition of U.S. real estate.

Because foreign investors, even those actively doing business in the United States, were able easily to avoid tax on their real property related capital gains, but were still entitled to advantageous net income taxation during the time they owned the property, they were placed in an economic position with respect to investing in U.S. real property that was more advantageous than that of U.S. citizens and domestic corporations. FIRPTA was enacted primarily to address this inequity by generally requiring that a foreign investor who disposes of an interest in U.S. real property be taxed on any resulting capital gain in the same manner and at the same rates that a U.S. person would be. To prevent easy avoidance of these rules by holding real property through corporations, FIRPTA also imposed tax on dispositions by foreign persons of interests in United States real property holding companies.*

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* The particular problems at which FIRPTA was directed were limited to those arising from foreign ownership of U.S. real estate. FIRPTA did not attempt to tax all capital gains derived from the disposition of investments in the United States. In particular, it was not thought appropriate to tax foreign taxpayers on income derived from their portfolio investments in securities traded on established U.S. securities markets. Accordingly, FIRPTA drew a distinction between dispositions of interests in U.S. real property holding companies and interests in other corporations, particularly those whose stock is widely held and publicly traded.

The enactment of FIRPTA brought United States tax policy into conformity with rules followed in many other countries. As the 1979 Treasury Department report indicated, many countries tax dispositions of real estate located within their borders. That principle is reflected in the OECD Model Income Tax Treaty and is consistent with the United States tax treaty negotiating position. While fewer countries tax indirect dispositions of property through the sale of shares in real estate holding companies, that practice also is not unusual among our trading partners. As a general matter, due to the security and attractiveness of an investment in U.S. real property, most foreign investors do not object substantively to the provisions of FIRPTA imposing tax on sales of real property. Indeed, new investment by foreign persons in United States real property has continued since the adoption of FIRPTA, and, in fact, the greatest annual new investment by foreign persons in U.S. real estate since Department of Commerce reporting was commenced in 1979 occurred in 1981, the year after FIRPTA's enactment.

The Treasury Department believed when FIRPTA was adopted that the inequities that I have described should be eliminated from our tax laws. We continue to support the concept embodied in FIRPTA that foreign taxpayers should be taxed on income that they derive from the disposition of interests in U.S. real property just as U.S. citizens are taxed on such income. We do not believe that FIRPTA's taxation of foreign persons on gains derived from the disposition of U.S. real estate has or will unduly restrict the desire of foreign persons to invest in U.S. real estate. The Treasury Department is therefore opposed to S. 1915, which, by repealing FIRPTA, would reinstate the provisions of prior law that favor foreign investment in U.S. real estate.

While we oppose its repeal, the Administration does believe that FIRPTA can be improved. In particular, the statutory reporting mechanism designed to aid the enforcement of the provisions of FIRPTA has been difficult to implement because of the scope of the information reporting required from foreign persons having little or no direct contact with the United States. In order to encourage compliance and aid enforcement, FIRPTA initiated a system of reporting ownership of U.S. real property interests by non-resident aliens and by domestic and foreign real property holding companies, trusts and partnerships, that are owned directly or indirectly by foreign investors. That reporting system requires foreign persons directly holding interests in U.S. real property to file an annual information return identifying themselves and the U.S. real property in which they hold an interest. Many corporations and other entities holding U.S. real property interests are also required to file annual information returns disclosing the real property they hold, the identity of their direct and indirect foreign shareholders, the percentage interest of those shareholders in the U.S. real property, and, in some cases, certain information regarding transactions in the corporation's stock during the year.

Our experience over the past four years attempting to implement the statutory reporting system has led us to conclude that the reporting system has serious deficiencies. First, and most fundamentally, a reporting system such as that prescribed by FIRPTA is largely ineffective as a means of policing a self-assessment system where the reporting person and the taxpayer are the same or under common control. A foreign taxpayer who would have failed to file a tax return and report thereon a sale of real property is extremely unlikely to file, or cause a corporation or partnership which he controls to file, the information returns required by the statute. To be effective, we believe that any reporting system must either call for reporting of transactions by disinterested parties or by parties whose interests run counter to those of the taxpayer with respect to which reported information is sought. Because the FIRPTA reporting system is a self-reporting system, it does not create any greater incentive to report than would exist under a typical voluntary compliance, annual tax return system.

Second, the reporting system imposes a tremendous administrative burden on the IRS. The required information return would identify individual foreign investors and their U.S. real estate holdings annually. In order for the IRS to use this information to identify a particular unreported disposition of real property, a manual comparison of an individual taxpayer's reports year by year would have to be made to determine if a particular real property interest had been deleted from the list. Given the large volume of information returns likely to be filed, it would be extremely difficult for the IRS to carry out such a matching exercise on a comprehensive basis. Since those foreign investors seeking to avoid U.S. tax would be unlikely to file accurate reports in any event, such a matching exercise would not represent an optimal use of the administrative resources of the IRS. Moreover, while FIRPTA makes provision for an alternative security agreement procedure that would enable a taxpayer to be exempted from the reporting requirement, full implementation of that procedure on a taxpayer-by-taxpayer basis also would involve a tremendous commitment of IRS administrative resources.

Finally, it will be difficult, if not impossible, for certain taxpayers to comply with the reporting that is called for by FIRPTA. Widely held reporting corporations, partnerships and trusts simply do not have, nor is it likely that they can obtain, some of the information regarding their direct and indirect shareholders or other owners and the pro rata interests of such owners in the real estate holdings of the entity that the statute would require to be reported. In addition, FIRPTA requires information reporting from some intermediary entities that in only very remote circumstances would have a U.S. income tax liability under the statute.

The FIRPTA reporting rules have been the target of very strong objections from foreign investors. While much of the reason for these objections is a simple desire on the part of foreign investors to keep their affairs confidential, many of the objections are more substantial.

Because of the many outlined problems with the reporting system, we have concluded that the FIRPTA reporting rules should be replaced with an alternative enforcement mechanism. The Conference Committee last week approved changes to FIRPTA which would repeal the reporting provisions of the statute as they relate to reporting of indirect ownership of U.S. real property interests. The proposal would replace the reporting rules with a tax withholding system. A form of a tax withholding system was proposed in the Administration's budget for fiscal year 1985. Under the proposed statutory change agreed to by the Conference Committee, the purchaser of an interest in U.S. real property from a foreign investor generally would be required to withhold 10 percent of the gross purchase price of the real property interest. There would be several exceptions to this general statutory rule. First, a purchaser who is uncertain as to whether the owner of property he is purchasing is a foreign person, and whether an obligation to withhold therefore arises, may protect himself from liability by obtaining from the seller an affidavit that the seller is not a foreign person. A purchaser would also have no obligation to withhold if he is acquiring U.S. real property for use as his residence for a purchase price of less than $300,000, regardless of whether the residence is purchased from a foreign taxpayer.* Finally, the amount required to be withheld can be reduced by applying to the Internal Revenue Service for a determination as to the amount of the tax actually due on the transaction.

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* A foreign seller still would be required to pay tax on income derived from the sale of such residential property.

The Treasury Department fully supports the changes to FIRPTA as approved by the Conference Committee. We believe that a withholding system of the type contemplated in the proposal would effectively facilitate the enforcement of FIRPTA. We also believe that the existing reporting system would be largely superfluous if a withholding mechanism for collecting the FIRPTA tax were in place. The approach taken by the Conference Committee will resolve the most difficult and controversial aspects of FIRPTA without abandoning the sound tax policy premises upon which that law is based. We would strongly urge the adoption of the Conference Committee proposal and the rejection of S. 1915.

Conclusion

I thank you, Mr. Chairman and Members of the Committee for the opportunity to present this statement regarding FIRPTA.

oOo

American Land Development Association, 5th Floor, 1220 L Street, NW, Washington, DC 20005 Phone: (202) 371-6700

July 2, 1984

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William B. Ingersoll
Ingersoll and Bloch, Chtd.
Washington, D.C.

The Honorable Robert Dole
Chairman
Senate Finance Committee
U.S. Senate
Washington, D.C. 20510

Dear Chairman Dole:

As Vice President of Government Relations for the American Land Development Association and on behalf of its members, I am presenting this statement to express our views on Senator Goldwater's bill, S. 1915. As you know, this legislation would repeal the 1980 Foreign Investment in Real Property Tax Act (FIRPTA), thus repealing the capital gains tax on the disposition of investments in U.S. real property by foreign investors, and also eliminating the requirement that these investors disclose their identity to the IRS. This statement has also been prepared in response to the recent hearings on S. 1915 held on June 19th before the Senate Finance Committee.

By way of background, the American Land Development Association (ALDA) represents leading national and international companies which develop resort, recreational and residential real estate including vacation homes, condominiums, resort timesharing, mobile home parks, and recreational vehicle parks and campgrounds. ALDA's membership includes the real estate development subsidiaries of some of the nation's largest corporations as well as privately held development companies. ALDA's international members number over 40 and represent such diverse countries as Australia, Morocco, Japan and Tahiti.

Additionally, the International Council is one of six councils within ALDA and was created especially to bring together capital and expertise from around the world to explore and carry out real estate investment and development in the United States, as well as monitor public policies that affect domestic and foreign real estate developers, lenders or investors.

ALDA strongly supports the repeal of FIRPTA. We believe the benefits of foreign investment to be enormous, creating not only increased availability of capital, but also additional jobs for American workers and improvements in the economic base of those regions in which development (resulting from a wide range of of new construction due to foreign investment in U.S. development projects) occurs. Foreign investment offers U.S. developers prime building opportunities which are in turn beneficial to the nation's economy at large.

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Since its introduction FIRPTA has proven to be a great burden to foreign investors in U.S. real property. The temporary regulations issued under FIRPTA are extremely complex, and no final regulations have been implemented by the IRS to determine such essentials as deadlines for compliance with FIRPTA's reporting requirements. The issuance of final regulations has been pending for three years already. This elapse of time is testimony to the complexity of FIRPTA and the accompanying burden it imposes on foreign investors in U.S. real property. and poses a clear question of the validity and soundness of imposing this act at all.

Also questionable are the equity and enforceability of the act, not to mention the harm it produces to the nation's economy. We need the investment of foreign capital, yet FIRPTA is chasing away foreign investors in real estate. Yet other nations, recognizing the value of foreign investors, actively encourage foreign investment, in some instances offering them privileged immigration visas.

In 1979 and 1980, foreigners invested more that $8.5 billion in U.S. real estate. Such expenditures have then and in succeeding years resulted in a wide range of new construction.

For example, a Canadian-based firm in Los Angeles is responsible for the development of the $1 billion California Center project consisting of three office towers, a hotel, apartment buildings, a modern art museum, a shopping center and theatre complex.

Yet another Canadian-based firm is responsible for the $180 million 730,000 foot office complex at 13th Street and New York Avenue here in Washington, D.C.

In Fort Lee, New Jersey, a Swiss-based investment group is responsible for the development of an $80 million luxury condominium project.

In Houston, a Hong Kong-based development company, in partnership with Houston's Apollo Land Development Co., is responsible for the development of a $500 million commercial and residential development and construction program.

As mentioned previously, there is also a question of the equity of FIRPTA. Foreigners investing in U.S. real property are only a fraction of those foreigners making investments in this country. Yet they are subjected to tax laws from which other foreign investors are exempt. For example, almost all foreign investments in stock issue of U.S. corporations are exempt from capital gains tax. Not only is FIRPTA discriminatory, but it unfairly applies to foreign investors who acquired land before the law was enacted.

And how should FIRPTA be enforced? As also mentioned previously the IRS is still struggling after three years to finalize regulations pertaining to the information reporting requirements of FIRPTA. In 1980, 1981, 1982 and 1984 withholding proposals were defeated by the Congress. What reasonable kind of a collection scheme exists?

Requiring the deposit of securities is not the answer either. As you are aware, those businesses who are not prepared to advise the IRS of the name, address and tax status of every individual who directly or indirectly has an ownership in U.S. land held by their company are required to provide the IRS with security adequate to ensure that potential tax liabilities will be satisfied. One of our members in particular was informed that they will have to provide at yearly intervals the appropriate appraisals of their land holdings and then deposit with the IRS funds equal to 28 percent of the difference between the bases and the appraised value. To implement FIRPTA in this manner is grossly unfair.

The American Land Development Association urges the repeal of the Foreign Investment in Real Property Tax Act in order to establish equity in the manner by which foreign investors in real property, bonds, securities, and other assets are taxed on capital gains. The repeal of FIRPTA would also restore the incentive to foreigners to invest in U.S. real property, thus increasing the availability of capital to U.S. developers, providing jobs and enhancing the economic base of those areas in which development takes place, and also contributing to the improvement of our economy at large.

Sincerely,

Thomas C. Franks
Vice President
Government Relations

TF/lr

cc: Gary Terry, President, ALDA

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D. C.

Comments, Points and Authorities in Support of Needed Revisions to the Foreign Investment in Real Property Tax Act of 1980 as Enacted under the Omnibus Reconciliation Act of 1980

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Comments, Points and Authorities in Support of Needed Revisions to the Foreign Investment in Real Property Tax Act of 1980 as Enacted under the Omnibus Reconciliation At of 1980

INTRODUCTION AND SUMMARY

In accordance with Press Release Number 84-140 issued by the United States Senate Committee on Finance on May 11, 1984, the purpose of this memorandum is to provide comments and recommendations regarding the Senate Finance Committee's hearing on June 19, 1984 concerning a bill to amend the United States Internal Revenue Code with respect to the tax treatment of dispositions of investments in United States real property by foreign persons as provided under the Foreign Investment in Real Property Tax Act ("FIRPTA"), enacted under the Omnibus Reconciliation Act of 1980.

At the outset, we wish to confirm our continuing support for the efforts of the Members and staff of the Senate Finance Committee ("SFC") and the House Ways and Means Committee ("HWMC"), the staff of the Joint Committee on Taxation ("JCT"), and senior officials of the United States Department of the Treasury ("Treasury") directed to resolving the complex issues which have arisen in this area. We particularly wish to recognize the efforts of Senator Barry M. Goldwater, who introduced S. 1915, and Chairman Robert Dole of the Senate Finance Committee, who scheduled the subject hearing on FIRPTA.

We also wish to express our appreciation for the efforts of Congressman Barber Conable, Ranking Minority Member of the HWMC, who has introduced legislation concerning this subject in the House (H.R. 5673 and H.R. 4328), and for the efforts of Congressman Sam Gibbons, Chairman of the HWMC Subcommittee on Trade, who has also introduced legislation to amend FIRPTA (H.R. 5326 and H.R. 5673). In this regard, it is also important to recognize that other Members of the HWMC have come forward as co-sponsors of these legislative initiatives directed to amending FIRPTA (Congressmen John Duncan, Ronnie G. Flippo, Bill Frenzel, Robert T. Matsui, and Guy Vander Jagt).

It is clear that the United States Congress has recognized the need for legislative revision of FIRPTA as demonstrated by the recent action of the House and Senate Conferees in the tax bill which has now been forwarded to the President of the United States which could result in a public law in the days ahead. These developments also support the need for further changes in FIRPTA as set out in the legislation sponsored by the various Members of the United States Congress noted above.

As related on various occasions in the past, we believe it is important to distinguish foreign investment in operating concerns actively involved in a United States trade or business (other than farming) from foreign passive investment in United States real property.

DISCUSSION

Historical Considerations

Original Congressional Intent which Led to the Enactment of FIRPTA under the Provisions of the Omnibus Reconciliation Act of 1980

FIRPTA was enacted under the provisions of the Omnibus Reconciliation Act of 1980.[1] Based on prior hearings held by the SFC and HWMC concerning previous legislative initiatives in this area, it is clear that the instigating factor which ultimately led to the enactment of FIRPTA was the preservation of United States farmland. It is important to note that the United States Congress did not intend to impose a penalty on foreign investors or to discourage foreign investment in the United States.[2] However, Congressional review of the proposed definitional techniques for applying FIRPTA was inevitably limited in scope as FIRPTA was considered very late in the 96th Congress as a part of the Omnibus Reconciliation Act of 1980, and therefore, understandably certain definitional provisions of FIRPTA failed to reflect the original Congressional intent noted above.

Specifically, while it is clear that the original policy goal of FIRPTA was to protect domestic farm ownership, the meaning of the term "real property holding corporation" was expanded to include gains from disposition of real property as well as gains

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1/ See Omnibus Reconciliation Act of 1980, 96th Cong., P.L. 96-499, 2d Sess., December 5, 1980.

2/ See House Committee on Ways and Means Budget Reconciliation Report of the Committee on Ways and Means, H.R. Rpt. No. 96-1150, Part I, 96th Cong., 2d Sess., p. 170.

from the disposition of securities issued by entities with substantial holdings of United States real property, which were treated as "United States Real Property Holding Companies" ("USRPHC"). Under FIRPTA, a USRPHC is defined to include any corporation where the fair market value of its United States real property and personal property associated with the use of such real property used in trade or business exceeds 50 percent of the fair market value of its world-wide real property interests and its other assets which are used or held for use in a trade or business. Unfortunately, under certain circumstances, FIRPTA applies to foreign investment in operating concerns actively engaged in a United States trade or business as well as foreign passive investment in United States real estate. In this regard, the inclusion of operating concerns under the USRPHC definition overreaches the original intent of the United States Congress which was to tax the capital gains of foreign passive investment in United States real estate and adversely affects important United States national and international interests.

International Economic Considerations which Support the Need for Legislative Revision of FIRPTA

It is not surprising that subsequent to the enactment of FIRPTA, the SFC, HWMC, JCT, the Treasury, and the Office of the United States Trade Representative recognized that FIRPTA may unintentionally impede and distort beneficial investment flows into the United States. These considerations are particularly important in the context of the rapidly increasing United States trade deficit.

Furthermore, FIRPTA is a disincentive to foreign investment in many basic United States industries. FIRPTA applies to gains from disposition of securities issued by entities with substantial holdings of United States real property as well as gains from disposition of real property; FIRPTA's definition of a USRPHC includes a great number of domestic manufacturing concerns with extensive plant requirements. Thus, transfers of stock in more capital intensive enterprises, which are deemed USRPHC's under FIRPTA, constitute dispositions of United States real property interests and subject foreign stock transferors to the tax. It is important to recognize that the United States federal government has consistently attempted to promote foreign investment in capital intensive industries in order to displace imports, encourage exports and stimulate domestic employment. Accordingly, any amendment to FIRPTA which distinguishes foreign investment in operating concerns actively engaged in a United States trade or business (other than farming) from foreign passive investment in United States real estate would clearly serve important United States national and international interests.

Recent Congressional Initiatives To Amend FIRPTA

Based in part on the factors set forth above, Senator Barry Goldwater, Congressman Barber Conable, Congressman Sam

Gibbons, and others have introduced legislation to eliminate international economic distortions which may be caused by FIRPTA. Although it may not be possible to repeal FIRPTA outright, nevertheless, it is clear that major revisions to FIRPTA are now necessary in order to promote equity and fairness in this area.

Senator Goldwater's legislation to amend FIRPTA is directed to eliminating disincentives to foreign investment in the United States and thereby increasing United States competitiveness and creating more United States jobs. 3/ In point of fact, at the June 19, 1984 hearing before the Senate Finance Committee, Senator Goldwater specifically noted that FIRPTA overreaches the original policy objective of preventing foreign takeovers of farm production land by imposing a capital gains tax on all types of foreign investment in United States real property. In addition, Senator Goldwater stated that FIRPTA discourages needed foreign investment which would increase the competitiveness of United States industries and create more United States jobs 4/ and the Senator set forth specific transactional examples in support of his arguments 5/ (see also additional transactional examples which are included as an attachment to this submission).

During the course of the SFC June 19, 1984 hearing regarding FIRPTA, it is clear from the testimony of the British

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3/ See Cong. Rec., 98th Cong., 1st Sess., Vol. 130, No. 129, October 3, 1983, pp. S-13470-73.

4/ See Statement of Senator Barry Goldwater before the Senate Finance Committee on S. 1915, June 19, 1984, p. 1.

5/ *Id.* at Footnote 1.

Association of Investment Trust Companies and for the European Federation of Pension Funds that United Kingdom firms with investments in the United States are concerned about the adverse effects of FIRPTA which appear to be inconsistent with stated United States international investment policy which is designed to encourage inflows of capital to reduce interest rate pressures and facilitate financing the United States record high trade deficit. [6/] Furthermore, it is clear that these points and arguments are also clearly a matter of concern to senior officials of the Government of the United Kingdom.

As noted previously, Congressman Barber Conable, Ranking Minority Member of the House Ways and Means Committee, has also introduced legislation in the United States House of Representatives for the purposes at hand. [7/] This legislation also seeks to substantially cut back the provisions of FIRPTA by repealing capital gains on disposition of foreign investment in United States property. In his floor statement before the House of Representatives, Congressman Conable stressed that the complexity of FIRPTA legislation itself has led to a great deal of uncertainty on the part of foreign investors with particular reference to onerous reporting requirements. [8/] This uncertainty

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[6/] See Statement of Lord Mark Fitzalan Howard, on behalf of the British Association of Investment Trust Companies, and Representative, European Federation of Pension Funds, before the Senate Finance Committee on S. 1915, June 19, 1984., p. 1.

[7/] See H.R. 5673 introduced on May 17, 1984 by Congressman Barber Conable; Cong. Rec., 98th Cong., 2d Sess., Vol. 130, No. 65, May 17, 1984, p. H-4162.

[8/] See Cong. Rec., 98th Cong., 2d Sess., Vol. 130, No. 66, May 18, 1984, p. E-2273.

is exacerbated by the difficulty Treasury has had in providing regulatory guidance relative to the extent reporting is required. In this regard, it is important to recognize that the Treasury has had major difficulties in issuing final regulations in this area. Moreover, Congressman Conable has noted that while outright repeal of FIRPTA may not be necessary to satisfy important United States policy considerations, he has urged that the United States Congress undertake action in the near future to resolve as many problems as possible in this area.

We also wish to express our support for the efforts of Congressman Sam Gibbons who has committed substantial efforts to making necessary changes in this area. 9/ In the interim context, both the HWMC and SFC have already attempted to resolve some of these problems as a consequence of the changes which they recommended during the recent tax conference on Tax Reform Act of 1984. 10/

CONCLUSION AND RECOMMENDATIONS

Based on the points, authorities, developments and considerations set forth above, we recommend that the Senate Finance Committee proceed expeditiously to implement further necessary legislative changes to FIRPTA taking into account the

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9/ See H.R. 5326 and H.R. 5673 introduced by Congressman Sam Gibbons and Congressmen Conable and Gibbons on April 3, 1984 and May 17, 1984, respectively; Cong. Rec., 98th Cong., 2d Sess., Vol. 130, No. 42, April 3, 1984, p. H-2233 and Cong. Rec., 98th Cong., 2d Sess., Vol. 130, No. 65, May 17, 1984, p. H-4162.

10/ See Conference Report on H.R. 4170, H. Rpt. No. 98-861, 98th Cong., 2d Sess., Section 129.

recent legislative initiatives of Senator Barry Goldwater, Congressmen Barber Conable and Sam Gibbons, and other Members of the United States Congress.

In conclusion, once again we wish to express our appreciation to the Members and staff of the Senate Finance Committee for their continuing efforts to resolve the difficult problems in this area.

July 1984

Respectfully submitted,

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Attachment

July 1984

Transactional Examples concerning Needed Changes to the Foreign Investment in Real Property Tax Act of 1980 Provisions of the Omnibus Reconciliation Act of 1980 (P.L. 96-499)

The recommended legislative changes would distinguish foreign investment in operating concerns actively engaged in a United States trade or business (other than farming) from foreign passive investment in United States real estate.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") was enacted into law under the provisions of the Omnibus Reconciliation Act of 1980 (P.L. 96-499) in an effort to protect United States farmland and certain other real property interests. Although a primary concern of the United States Congress in enacting FIRPTA was preservation of United States real property interests, owing to pressing timing considerations, this legislation was enacted in circumstances which may not have allowed adequate opportunity to review certain definitional provisions. Based on the prior hearings of the House Ways and Means Committee and the Senate Finance Committee on legislative initiatives in this area, it appears that the original intent of Congress may not have been properly reflected under the FIRPTA provisions as set out under the Omnibus Reconciliation Act of 1980 and that the effect of these provisions may sometimes be contrary to important United States national and international interests.

As enacted, FIRPTA fails to distinguish between foreign investment in operating concerns actively engaged in a United States trade or business (other than farming) and foreign passive investment in United States real property. Consequently, FIRPTA serves as a disincentive to the continued inflow of beneficial foreign capital investment into manufacturing and production firms which would result in the creation of United States jobs.

The recommended changes would remove this disincentive by limiting FIRPTA coverage to passive foreign investment in United States real property, thereby stimulating productive foreign investment in operating concerns actively engaged in a United States trade or business. Such investment in operating and manufacturing firms could result in displacing United States imports and stimulating United States exports, thus producing a favorable impact on the United States trade balance and United States employment.

The transactional examples set forth below are intended to demonstrate the need for the recommended changes and to distinguish between beneficial foreign capital investment in firms actively engaged in a United States trade or business which would be excluded from FIRPTA while continuing to apply FIRPTA to those situations which originally concerned the Congress. The first set of examples notes transactions which would be covered by the changes (exempt transactions), while the second set of examples relates transactions which would not be subject to the changes (covered transactions).

Exempt Transactions

1. A United States corporation involved in production and sale of plastic chemical products wishes to enter into a joint venture with a Dutch plastic products corporation under which the United States corporation would offer a part of its stock in exchange for know-how and production rights for certain products. The Dutch corporation considers the potential return on its investment in the United States corporation and determines that under current United States law it would be subject to capital gains taxation on the disposition of its investment in the United States corporation. Therefore, the Dutch corporation may decide not to proceed with the transaction given the present United States tax disincentive. Under the recommended legislative changes, the Dutch corporation would be exempt from FIRPTA, which could result in providing the United States corporation with the benefits of the Dutch corporation's technology and production rights, thus increasing the competitiveness of the United States corporation and creating more United States jobs.

2. Owing to international trade considerations, a Japanese corporation engaged in automobile manufacturing in Japan is considering establishment of a United States subsidiary corporation to produce automobiles in the United States for United States consumption in an effort to reduce Japanese exports of automobiles to the United States. In considering the tax implications involved in such a substantial investment, the Japanese automobile manufacturer determines that it could be subject to United States capital gains taxes under the provisions of FIRPTA. Accordingly, the Japanese manufacturer may decide not to establish the United States manufacturing subsidiary. Under the recommended legislative changes, the Japanese automobile manufacturer could proceed with its investment which could result in substantial benefits to the United States, including increased United States employment and a reduced United States trade deficit with Japan.

3. A United Kingdom corporation engaged in paper manufacturing and processing wishes to invest in a United States firm engaged in timber and pulp manufacturing to produce paper

products for United States consumption and for possible export to other countries. While investigating the potential return on such an investment, the United Kingdom corporation determines that under FIRPTA disposition of the stock in a United States timber, pulp, and paper producer could subject the United Kingdom corporation to United States capital gains tax. Under the recommended legislative changes, the United Kingdom corporation could invest in the United States corporation, thus increasing United States jobs in the timber, pulp, and paper manufacturing industries, while at the same time increasing the prospects for expanding exports of United States timber, pulp, and paper products.

Covered Transactions

1. A Saudi Arabian investor wishes to establish a United States corporation to acquire United States farmland. The Saudi investor intends to later liquidate its investment by selling the stock of the United States corporation. Under existing law and the recommended legislative changes, the gain on the sale of shares in the United States corporation would to subject to United States capital gains tax pursuant to FIRPTA and would thus deter foreign investment in United States farmland.

2. A syndicate of German individuals wishes to invest in condominiums in the coastal regions of the United States. The German syndicate intends to establish a United States corporation which would purchase and sell condominium units. After a period of time, the German syndicate intends to sell its stock in the United States corporation. Under existing law and the recommended changes, the German syndicate would continue to be subject to United States capital gains tax pursuant to FIRPTA and would thus deter such passive investment in United States real estate.

3. A consortium of European Banks wishes to purchase interests in United States shopping centers located near various urban areas. Subsequently, the European Banks intend to sell their interests in the shopping centers. Under existing law and the recommended changes, the European Banks would be subject to United States capital gains taxation under FIRPTA as this transaction would not involve a qualified investment in an operating concern actively engaged in a United States trade or business.

It is suggested that the transactional examples and policy considerations noted above support the need for the United States Congress to adopt the recommended legislative changes to FIRPTA to assure that foreign investment in operating concerns actively engaged in a United States trade or business (other than farming) is properly distinguished from foreign passive investment in United States real estate and that investment in such operating concerns is not subject to FIRPTA.

STATEMENT OF

Professor Richard L. Kaplan
College of Law
University of Illinois

For the Public Hearing on S. 1915
June 19, 1984

I am an associate professor of law at the University of Illinois teaching in the area of federal taxation and specializing in the taxation of international transactions. Before entering the professoriate in 1979, I practiced law with Baker & Botts in Houston, Texas, specializing there also in matters involving international taxation. These experiences have shaped my perspective on foreign investment in real estate and have led me to conclude that the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) is bad legislation and should be repealed *in toto* posthaste. I have explained my position in some detail in an article entitled "Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate," which was published in 71 *Georgetown Law Journal* 1091-1128 (1983). I am attaching a copy of my article to this Statement and would direct the attention of this Committee in particular to pages 1117-1120, which consider the problems inherent in the thrice-rejected approach of tax withholding, and pages 1120-1128, which examine the policy concerns that FIRPTA purported to address.

Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*

Richard L. Kaplan**

Prior to 1980 certain nonresident alien individuals and foreign corporations were exempt from United States tax on their United States source capital gains that were not effectively connected with the conduct of a trade or business within the United States. Congress enacted the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) to close this perceived loophole to the extent that it exempted gains derived from sales of United States real estate. In this article Professor Kaplan analyzes the pre-FIRPTA tax regime and the modifications introduced by FIRPTA. Professor Kaplan argues that the loophole addressed by FIRPTA not only was of minor significance, but was consciously created because of the difficulty of collecting taxes on the capital gains of nonresident, nonbusiness foreign investors, and was justifiable on additional policy grounds. In partially closing this limited loophole, FIRPTA complicates the tax code, overrides bilateral tax treaty provisions, and creates an intrusive but unenforceable collection scheme. Professor Kaplan suggests that FIRPTA can only be understood as an attempt to discourage foreign investment in United States real estate—a xenophobic goal, lacking any economic or common sense rationale, which FIRPTA is in any case unlikely to accomplish—and recommends that FIRPTA be repealed in its entirety.

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I. INTRODUCTION

For many years the subject of foreign ownership of United States property was the concern primarily of international investment advisors and economic theorists. In the decade of the 1970's, however, this arcane topic became the focus of widespread concern and intense debate.[1] The popular television news program, "60 Minutes," devoted an entire segment to foreign purchases of United States farmland, and the American Bar Association began sponsoring annual courses on foreign investment planning geared toward general practitioners, not just international law specialists.[2]

The increased attention given to foreign holdings of United States real estate is directly related to the perceived phenomenal expansion of such holdings in recent years.[3] International investors had long been attracted to United States investments because of the relative stability of this country's economic and political systems, as well as the sheer enormousness of the investment market itself.[4] But this attraction became even stronger in the 1970's because of favorable foreign currency fluctuations,[5] the rise of local communist movements overseas, and other destabilizing events. At the same time, skyrocketing petroleum prices concentrated more investable funds in the hands of some foreign investors than had ever been the case before.[6] By the end of 1980, in fact, alternatives available. The reports required of foreign investors by the International Investment Survey Act[180] are confidential and not available to tax collectors.[181] Reports required by the Agricultural Foreign Investment Disclosure Act,[182] on the other hand, are open to the public[183] but are limited to farmland and do not include urban real estate holdings.[184] In any case, the use of one unwieldy mass of data to cross-check another such mass, each created under different statutory parameters, seems likely to generate more confusion than assistance. Information reporting alone, quite obviously, cannot ensure FIRPTA's enforceability.

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[1] *See, e.g.*, K. CROWE, AMERICA FOR SALE (1978); E. FRY, FINANCIAL INVASION OF THE U.S.A.: A THREAT TO AMERICAN SOCIETY? (1980), *reviewed in* Kaplan, Book Review, 129 U. PA. L. REV. 486 (1980); Lanier, *The New Kids on the Block*, CHICAGO, Apr. 1982, at 148; Rubin, *The Selling of California*, 9 CAL. J. 409 (1978); Samuelson, *Make Way—The Foreign Investors Are Coming*, 10 NAT'L J. 664 (1978); Drinkhall & Guyon, *Real-Estate Purchases By Foreigners Climb, Stirring Wide Debate*, Wall St. J., Sept. 26, 1979, at 1, col. 1; *Foreign Investors Flock to U.S. Farmlands*, BUS. WK., Mar. 27, 1978, at 70.

[2] *See* 13 A.B.A.-A.L.I. CLE REVIEW No. 30, at 4 (1982).

[3] *See* U.S. DEP'T OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE 5-14 (1979) (although newspaper accounts indicate rapid growth in foreign investment in United States real property in 1970's, available statistics inadequate and conflicting) [hereinafter TREASURY REPORT].

[4] *See* U.S. GEN. ACCOUNTING OFFICE, FOREIGN INVESTMENT IN U.S. AGRICULTURAL LAND—HOW IT SHAPES UP 68-80 (1979) [hereinafter GAO REPORT]; Katz, *Foreign Direct Investment in the United States—Advantages and Barriers*, 11 CASE W. RES. J. INT'L L. 473, 474-76 (1979).

[5] *See* E. FRY, *supra* note 1, at 36 (during seven years ending in April 1978, dollar declined 63% against Japanese yen, 81% against German mark, and 131% against Swiss franc).

[6] Observers estimated that surpluses held by Arab oil exporters could amount to $120 billion in 1980, up from $5.3 billion only two years earlier. *Arab Banks Grow*, BUS. WK., Oct. 6, 1980, at 70, 72; Paul, *Arabs Buying Up U.S.? For Now, at Any Rate, They Aren't Interested*, Wall St. J., Aug. 18, 1980, at 1, col. 6.

B. WITHHOLDING SALES PROCEEDS

To ensure collection of taxes owed by nonresidents who are not engaged in United States business activities, the Code has long relied on withholding these taxes from the investor's income.[185] Taxes on interest income, dividends, rents, and other "fixed or determinable annual or periodical income"[186] are simply withheld by the person making such payments and remitted to the government on the foreign investor's behalf. Should the person making these payments fail to withhold the required amounts, that person is subject to assessment, plus penalties, for the amounts not so withheld.[187]

Such a withholding system was part of FIRPTA's original conception[188] and was included in the Senate's version of that enactment.[189] The House of Representatives, however, objected to this idea and deleted it from the final bill.[190]

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[180] 22 U.S.C. §§ 3101-3108 (1976 & Supp. V 1981). *See supra* notes 10-15 and accompanying text (discussing the Act's reporting requirements).

[181] *See* 15 C.F.R. § 806.5 (1982) (information available only to administrators of program); *see also* H.R. Rep. No. 1490, 94th Cong., 2d Sess. 3 (1976), *reprinted in* 1976 U.S. Code Cong. & Ad. News 4663, 4665 (same).

[182] 7 U.S.C. §§ 3501-3508 (Supp. V 1981). *See supra* notes 17-19 and accompanying text (discussing the Act's reporting requirements).

[183] 7 U.S.C. § 3506.

[184] *See id.* §§ 3501, 3508.

[185] *See* I.R.C. § 1441 (nonresident aliens), *id.* § 1442 (foreign corporations). *See generally* 3 B. Bittker, *supra* note 37, ¶ 66.6 (discussing withholding of tax at source); 1 R. Rhoades & M. Langer, *supra* note 72, § 2.24 (same); S. Roberts & W. Warren, United States Income Taxation of Foreign Corporations and Nonresident Aliens ch. VIII (1966 & Supp. 1967) (same); Dale, *Withholding Tax on Payments to Foreign Persons*, 36 Tax L. Rev. 49 (1980) (same). The rate of tax withheld is 30% of gross receipts unless otherwise specified by the Code, I.R.C. §§ 1441, 1442 (1976), or an applicable treaty. *See id.* § 7852(d); *see also* Internal Revenue Service, Withholding of Tax on Nonresident Aliens and Foreign Corporations 16-17 (Pub. No. 515, 1980), *reprinted in* 2 R. Rhoades & M. Langer, *supra* note 72, at A-16 to A-17 (tabular listing of withholding rates for each type of income by treaty country).

[186] *See* I.R.C. §§ 871(a)(1)(A), 881(a)(1) (1976).

[187] *Id.* §§ 1461, 6672(a), 7202, 7501(a) (1976 & Supp. V 1981). *See generally* 4 B. Bittker, *supra* note 37, ¶ 114.3.5 (discussing consequences of failure to withhold and collect third-party taxes); Dale, *supra* note 185, at 77-84, (discussing liability of "underwithholding agent").

[188] *See* S. 208, 96th Cong., 1st Sess. § 1(b), 125 Cong. Rec. 929 (1979) (capital gains of nonresident aliens and foreign corporations from sale of United States agricultural land would be subject to the Code's withholding provisions); *see also* H.R. 3106, 96th Cong., 1st Sess., 125 Cong. Rec. 5598 (1979) (similar legislation in House).

[189] *See* S. 2939, 96th Cong., 2d Sess. § 203(a), 126 Cong. Rec. S9312 (daily ed. July 2, 1980) (capital gains of nonresident aliens and foreign corporations from sale of all United States real property interests would be subject to Code's withholding provisions); *see also* S. Rep. No. 504, 96th Cong., 1st Sess. 9-11 (1979) (purchaser required to withhold tax); Richards, *The Foreign Seller of U.S. Real Estate: Withholding Requirements*, 6 Int'l Tax J. 292 (1980) (discussing proposed legislation).

[190] H.R. Rep. No. 1479, 96th Cong. 2d Sess. 189-90 (1980).

In explaining this action, the Conference Committee stated:

> [I]t would be necessary to structure withholding provisions carefully to ensure that they would not inadvertently disrupt the U.S. real estate market or expose U.S. buyers or U.S. agents of foreign sellers of U.S. real estate to liability where such liability would not be appropriate. Given this potential, the . . . withholding provisions should not be adopted until they could be more fully considered . . . and the public had adequate opportunity to consider and comment on the proposed withholding mechanism.[191]

Despite this request for more deliberate consideration, the Senate included a very similar withholding scheme in its version of the Economic Recovery Tax Act of 1981.[192] Once again, however, the House conferees objected, and the provisions were removed from the final bill, this time without any explanatory comment.[193] The Senate continued its campaign and included a withholding mechanism in its version of the Tax Equity and Fiscal Responsibility Bill of 1982.[194] But as before, the House conferees insisted upon its removal.[195] Thus, FIRPTA has no withholding mechanism and seems unlikely to get one anytime soon.

The House's hesitancy to enact a withholding mechanism could be attributed to several problems inherent in that approach, not the least of which being when such withholding should apply. FIRPTA does not affect gains realized by aliens who are United States "residents" or by foreign investors who are engaged in a United States "trade or business," because those gains are already taxable by the United States.[196] Only gains realized by nonresident, nonbusiness investors are subject to FIRPTA's amendments.[197] In other words, any withholding mechanism for FIRPTA gains would require the withholding agent—potentially, any buyer of United States real estate—to determine not only whether the "real" seller is a foreign investor, but also whether that foreign investor is a nonresident not engaged in a United States trade or business. This latter determination is often quite difficult even when all the relevant facts are known.[198] To obligate every purchaser of United States real estate to make this determination would be unreasonably burdensome and potentially very disruptive.

On the other hand, this obligation is already imposed on payors of periodic payments, such as interest and dividends, that are subject to withholding requirements at the present time.[199] These requirements also apply only if a foreign recipient does not engage in a United States trade or business,[200] and a system of statements and certifications has been instituted to limit the withholding agent's exposure on this question.[201] Even so, the system is far from perfect, and persons making such payments tend to overwithhold to limit their potential liability.[202] In any case, the payors affected by the existing withholding system are, by and large, sophisticated financial institutions, while FIRPTA-related withholding requirements could conceivably affect every real estate buyer in the United States.

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[191] *Id.*

[192] H.R.J. Res. 266, 97th Cong., 1st Sess. § 831, 127 Cong. Rec. S8472-74 (daily ed. July 27, 1981).

[193] *See* H.R. Rep. No. 215, 97th Cong., 1st Sess. 280 (1981).

[194] H.R. 4961, 97th Cong., 2d Sess. § 371(a), 128 Cong. Rec. S8639-41 (daily ed. July 19, 1982).

[195] *See* H.R. Rep. No. 760, 97th Cong., 2d. Sess. 588 (1982).

[196] *See supra* notes 32-87 and accompanying text.

[197] *See supra* notes 88-137 and accompanying text.

[198] *See supra* notes 45-57 and accompanying text (discussing real estate ownership as a "business").

[199] *See* I.R.C. § 1441 (1976) (nonresident aliens), *id.* § 1442 (foreign corporations); *supra* note 185.

[200] I.R.C. §§ 1441(c), 1442(a) (1976).

More fundamentally, the analogy to interest and dividend withholding is not appropriate for several structural reasons. First, in the case of interest, dividends, or similar receipts, the entire amount of the payment constitutes gross income.[203] In real estate sales, however, only the *gain* is taxable; that is, only the difference between the sales proceeds and the property's basis represents taxable receipts.[204] Moreover, the relevant basis figure is the *seller's* basis, which the buyer—who would have the withholding responsibility—has no easy way of determining. The seller could simply inform the buyer of his basis, of course, but such information is extremely sensitive. If the buyer learns the exact size of the seller's gain, the buyer might feel cheated and may want to renegotiate the sales price. This reaction is particularly likely when, as in the case of FIRPTA, the seller reaping the profit is a foreign investor. On the other hand, if the foreign seller overstates his basis to minimize this reaction, his gain is understated and the tax withheld will be inadequate. Although the law could require that a fixed percentage of the gross sales price be withheld,[205] that approach would almost always be wrong, overwithholding in some cases and underwithholding in others. The simple fact remains that the sales price is not taxable income; only the gain realized, *if any*, is taxable.

Further, even a withholding mechanism based on sales prices would be difficult to implement. Unlike interest and dividend payments, which are usually made in cash, real estate transactions are typically consummated with very little cash actually changing hands. Mortgages, newly created or simply assumed; agreements to pay certain expenses when due; promissory notes, secured by land or unsecured; and other noncash media are common components of real estate sales. How does one withhold ten percent, for example, from an assumed mortage? On promissory notes, does one withhold part of the note's discounted value, or does one wait until the payments are actually made? If the latter, what if the foreign investor's status as a nonresident or as not-engaged-in-business changes by then? In short, withholding sales proceeds in a real estate context is often impractical.

To be sure, each of these problems is solvable, at least to some degree. Certifications could be formulated to let real estate buyers know with whom they are dealing.[206] De minimis exemptions could be created to reduce the paperwork and liability problems on smaller transactions.[207] Withholding on gross sales proceeds could be set at a sufficiently low rate to reduce overwithholding and could be made applicable only to cash proceeds controlled by the buyer.[208] But each of these proposals severely limits the withholding mechanism's ability to ensure the ultimate collection of the tax owed, which is, after all, the whole purpose of the mechanism. Yet, the absence of any withholding mechanism places the entire burden of enforcing FIRPTA on the reporting requirements discussed previously,[209] which clearly are not up to the task. Thus, there are significant chinks in FIRPTA's armor with respect to enforceability,[210] raising the question whether this new statute ought to exist at all.

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[201] *See* Treas. Reg. §§ 1.1441-4(a)(2), (b)(2), (d)(2), (f)(2)(i) (1981), 1.1441-5(a) (1973), 1.1441-6(c) (1971) (requiring recipient to file statement of exemption from withholding with withholding agent).

[202] *See* Dale, *supra* note 185, at 76-84.

[203] I.R.C. §§ 871(a)(1)(A), 881(a)(1) (1976).

[204] *Id.* §§ 1001(a), (b), 1011(a).

[205] *See* Note, *Withholding from Recipients of FIRPTA Gain*, 35 VAND. L. REV. 439, 467-68 (1982) (proposing such an approach); *see also* H.R. 4961, 97th Cong., 2d Sess. § 371(a)(1), 128 CONG REC. S8639-41 (daily ed. July 19, 1982) (not enacted) (incorporating such an approach) [hereinafter 1982 Proposal]. *But see* Angell, *The Nonresident Alien: A Problem in Federal Taxation of Income*, 36 COLUM. L. REV. 908, 911-12 (1936) (arguing that "[i]t would be futile for Congress to undertake to exact a contribution out of the sales price").

VI. POLICY CONSIDERATIONS

As analyzed thus far, FIRPTA seems to be an almost perverse enactment. To repeal a relatively limited exemption of some forty-four years standing, Congress expended inordinate legislative effort in five separate sessions.[211] The resulting statute is complex, difficult to enforce, and disrespectful of existing tax treaty obligations.

Yet, FIRPTA was not some quirk of the legislative mill or the irrational obsession of some obscure Congressperson. Very much to the contrary, this legislation had no fewer than 49 *sponsors* in the Senate[212] and 151 sponsors in the House of Representatives.[213] FIRPTA, in other words, was one of the most popular pieces of tax legislation considered in recent years. It obviously responded to some rather widely-held views about appropriate tax policy, and it is those views that this section now examines. The section first addresses the question of unequal tax treatment for domestic and foreign investors that FIRPTA purports to correct. It then analyzes the effect FIRPTA will have on foreign investment in United States real estate. Finally, it considers whether such investment ought to be a matter of legislative concern at all.

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[206] *See* 1982 Proposal, *supra* note 205 (proposing addition of I.R.C. § 1444(c), which would require foreign seller to furnish notice to his buyer); *supra* note 201 (same).

[207] *See* 1982 Proposal, *supra* note 205 (proposing addition of I.R.C. § 1444(d)(3), which would exempt principal residences that cost no more than $200,000).

[208] *See* 1982 Proposal, *supra* note 205 (proposing addition of I.R.C. § 1444(a)(2), which would require withholding 20% of amount realized or consideration that is within buyer's control, whichever is less). *But see id.* (proposing addition of I.R.C. § 1444(h)(4), which would include as consideration fair market value of property and face amount of any indebtedness that was created within two years of sale).

[209] *See* I.R.C. § 6039C (Supp. V 1981); *supra* notes 161-84 and accompanying text.

[210] *But see* Feder & Parker, *The Foreign Investment in Real Property Tax Act of 1980*, 34 TAX LAW. 545, 578-79 (1981) (suggesting that foreign investors will comply voluntarily if they expect ever to invest in United States again).

[211] *See* S. 3414, 95th Cong., 2d Sess., 124 CONG. REC. 34,604 (1978) (reprinted as amendment 3988 to H.R. 13,511); S. 192, 96th Cong., 1st Sess., 125 CONG. REC. 795, 796 (1979); Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121-1125, 94 Stat. 2599, 2682; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 831, 95 Stat. 172, 352; H.R. 4961, 97th Cong., 2d Sess. § 371(a) (1982).

[212] *See* S. 3414, 95th Cong., 2d Sess., 124 CONG. REC. 34,604 (1978) (reprinted as amendment 3988 to H.R. 13,511).

[213] *See* H.R. 3106, 96th Cong., 1st Sess., 125 CONG. REC. 5598 (1979).

A. TAXING DOMESTIC AND FOREIGN INVESTORS

If an American citizen, or an alien who resides in the United States, or a nonresident alien who engages in a United States trade or business, invests in United States land, his gain upon disposition of that land is usually taxable.[214] Oftentimes, this gain will qualify for favorable treatment as a capital gain,[215] but it is taxable nevertheless. In contrast, certain foreign investors who do not engage in a United States "trade or business"[216] are exempt from tax on their United States source capital gains, including gains derived from sales of United States real estate. That, in a nutshell, is the dichotomy FIRPTA abolishes. Under FIRPTA, real estate profits are now taxable, no matter how limited a foreign investor's United States contacts may be.[217]

In fact, eliminating this dichotomy was the principal reason put forward for FIRPTA's enactment. As the Committee Report explained:

> The committee believes that it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors. *The committee does not intend* by the provisions of this bill to impose a penalty on foreign investors or *to discourage foreign investors from investing in the United States*. However, the committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property . . . [by] effectively exempting [the foreign investor] from U.S. tax on the gain realized on disposition of the property.[218]

The Committee, quite obviously, tried to eschew any motive other than erasing this inequality of tax treatment and justified this single objective by invoking the principle of "horizontal equity," the idea that persons who are similarly situated should be taxed similarly.[219]

But it is not so clear that this principle really applies to domestic and foreign taxpayers. Domestic taxpayers, after all, enjoy all of the protections and benefits of United States law and participate fully in the commercial life of this country. Foreign investors who do not engage in a United States "trade or business," on the other hand, are prototypically passive. Their involvement in United States commercial activity is not ongoing and extensive, or else they would probably be taxable even under pre-FIRPTA law.[220] These investors, quite simply, are not similarly situated to domestic taxpayers, and disparate tax treatment for these two groups, therefore, is not necessarily inappropriate.

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[214] I.R.C. §§ 871(b)(1), 882(a)(1), 1001(c) (1976 & Supp. V 1981). For nonresidents, the gain must also be "effectively connected" with the taxpayer's United States trade or business. *Id.* § 864(c)(1)(A), (2) (1976). *See generally supra* notes 32-87 and accompanying text (discussing pre-FIRPTA taxation of foreign investments in United States land).

[215] *See* I.R.C. §§ 1221, 1222 (1976 & Supp. V 1981). *See generally* 2 B. BITTKER, *supra* note 37, ch. 50 (taxation of capital gains and losses).

[216] *See supra* notes 40-57 and accompanying text (discussing "trade or business" determination).

[217] I.R.C. § 897(a)(1) (Supp. V 1981). *See generally supra* Part III (discussing FIRPTA provisions).

[218] S. REP. NO. 504, 96th Cong., 1st Sess. 6 (1979) (emphasis added). This report accompanied the bill that was subsequently enacted as FIRPTA.

Curiously enough, even dispassionate students of foreign investment policy found this inequality of tax treatment abhorrent and urged its elimination. *See, e.g.,* GAO REPORT, *supra* note 4, at 32-33; E. FRY, FINANCIAL INVASION OF THE U.S.A. 147 (1980); Sisson, *The Tax System and the Structure of American Agriculture*, 9 TAX NOTES 419, 423 (1979).

[219] *See generally* 1 B. BITTKER, *supra* note 37, ¶ 3.1.4 (defining and discussing horizontal equity).

[220] *See* Lowenhaupt v. Commissioner, 20 T.C. 151, 162-63 (1953) (discussing amount of ongoing

Moreover, even if all real estate investors are considered similarly situated, that does not foreordain equivalent tax treatment. The horizontal equity principle merely suggests such equivalency in the absence of countervailing factors. It is not hyperbole to say that the Code is awash in countervailing factors, with the result that horizontal equity is honored more in the breach than in the observance. In each breach, some reason was thought sufficient to justify disparate—usually preferential—tax treatment, whether it was to stimulate exports,[221] encourage philanthropy,[222] promote energy conservation,[223] or preserve our architectural heritage.[224] But the point is that the horizontal equity concept, even when applicable, does not preclude disparate tax treatment. It merely requires a justification for such treatment.

With respect to foreign investors, several possible justifications suggest themselves. Difficulty in enforcing taxes on nonresident, nonbusiness investors—the raison d'etre of the original exemption[225] —is certainly one. Concessions made in bilateral tax treaties might be another.[226] Still another reason for disparate tax treatment might be to encourage foreign investment in the United States. This country historically has encouraged such investments,[227] and tax incentives are a well-accepted means of doing so.[228] Thus, Congress could easily justify treating foreign and domestic taxpayers differently, even if they were thought to be "similarly situated."

But the whole notion that the purpose of FIRPTA was to correct a breach of "horizontal equity" is itself rather spurious. In point of fact, the breach persists, even after FIRPTA, whenever an investor's gains derive from listed securities, commodities, bonds, or any capital asset other than real estate.[229] If preferential treatment of foreign investors is such a pernicious affront to horizontal equity, why was its eradication limited to real estate gains? It is this

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activity needed to constitute a United States "trade or business"), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955). *See generally supra* notes 48-57 and accompanying text (discussing *Lewenhaupt*).

[221] *See* I.R.C. § 911 (1976 & Supp. V 1981) (partial exclusion of foreign source earnings of United States expatriates), *id.* §§ 991-997 (partial deferral of export profits of a "domestic international sales corporation") (1976 & Supp. V 1981). *See generally* Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel*, 34 TAX LAW. 691 (1981) (discussing taxation of foreign earned income); Kingson, *A Somewhat Different View*, 34 TAX LAW. 737 (1981) (same); Postlewaite & Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal*, 65 VA. L. REV. 1093 (1979) (same).

[222] *See* I.R.C. § 170 (1976 & Supp. V 1981) (deduction for charitable contributions).

[223] *See id.* § 48(*l*) (Supp. V 1981) (tax credits for investments in qualifying "energy property").

[224] *See id.* § 48(g)(3) (tax credits for rehabilitating a "certified historic structure"); *see also id.* § 280B (1976 & Supp. V 1981) (denial of deduction for expenses of demolishing such structure).

[225] *See supra* notes 158-59 and accompanying text.

[226] *See generally supra* notes 138-55 and accompanying text (discussing intersection of FIRPTA and tax treaties).

[227] *See generally* Niehuss, *Foreign Investment in the United States: A Review of Government Policy*, 16 VA. J. INT'L L. 65 (1975) (discussing United States encouragement of foreign investment); Comment, *Foreign Direct Investment in the United States: Possible Restrictions at Home and a New Climate for American Investment Abroad*, 26 AM. U. L. REV. 109 (1976) (same).

[228] *See* Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539; S. REP. No. 1707, 89th Cong., 2d Sess. 9 (1966). *See generally* Choate, Hurok & Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers: History, Analysis and Prospects*, 44 TEMP. L.Q. 441 (1971) (historical background on United States encouragement of foreign investment).

[229] *See* I.R.C. §§ 871(a)(2), 881(a), 897(a)(1) (1976 & Supp. V 1981).

limitation that shows unmistakably that FIRPTA was intended to do far more than simply correct a disparity between foreign and domestic investors. Notwithstanding the statement quoted previously from the Committee Report,[230] FIRPTA was intended to discourage foreign investment in United States real estate. The question then becomes whether this statute will indeed have that effect.

B. EFFECT ON FOREIGN INVESTMENT IN UNITED STATES REAL ESTATE

Foreign investors are attracted to United States real estate for many different reasons. Among these are this country's stable political system,[231] relatively low rates of inflation, clearly articulated respect for private property, relatively inexpensive land prices,[232] and good prospects for capital appreciation.[233] Some foreign investors have additional reasons, such as securing a "safe haven" in the event that political upheaval at home necessitates a speedy departure.[234] The absence of a tax upon disposition, however, does not seem to be a major consideration; in comparison with the other factors at play, it is downright trivial.[235] After all, a tax upon disposition has absolutely no impact on a foreign investor unless he disposes of the property. Until then, any tax advantage, or "inducement" as the Committee Report called it,[236] is irrelevant.

That being the case, how can FIRPTA hope to affect foreign investment in United States land? It might deter foreign speculators perhaps, but most foreign investors come to the United States for long term, even permanent, investments.[237] To them, the panoply of relevant investment incentives—stable economy, "safe haven," and so forth—remains unchanged. Hence, FIRPTA is unlikely to affect the level of aggregate foreign investment in United States real estate to any discernible degree.

Yet, proponents of the new statute apparently believed that the capital gains exemption had not only increased aggregate foreign investment in United States real estate, but had also, by itself, precipitated higher land prices. In the words of Senator Church, one of FIRPTA's cosponsors:

> This tax loophole gives foreign investors a special advantage in the purchase of U.S. land by enabling them to pay higher prices than can any U.S. investor or farmer, who must take into consideration that he will have to pay the full capital gains tax in the event he should sell

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[230] *See supra* text accompanying note 218.

[231] *See* Katz, *Foreign Direct Investment in the United States—Advantages and Barriers*, 11 CASE W. RES. J. INT'L L. 473, 475-76 (1979).

[232] *See* SENATE COMM. ON AGRICULTURE, NUTRITION, AND FORESTRY, 95TH CONG., 2D SESS., FOREIGN INVESTMENT IN UNITED STATES AGRICULTURAL LAND III 12 (Comm. Print 1979) (comparable land in Europe sells for 50-100% more) [hereinafter SENATE STUDY].

[233] *See generally* GAO REPORT, *supra* note 4, at 68-80.

[234] *See* Azrack & Roberts, *Foreign Real Estate Practices and the Economy*, in 3 U.S. DEP'T OF AGRICULTURE, MONITORING FOREIGN OWNERSHIP OF U.S. REAL ESTATE 69, 70 (1979).

[235] *But see* GAO REPORT, *supra* note 4, at 69, 70 (tax advantages are consideration for small percentage of foreign investors).

[236] *See supra* text accompanying note 218.

[237] *See Impact of Foreign Investment in Farmland: Hearings on H.R. 13128 and Related Bills Before the Subcomm. on Family Farms, Rural Development, and Special Studies of the House Comm. on Agriculture*, 95th Cong., 2d Sess. 125-26 (1978) (statement of William A. Stiles, Senior Vice President of Oppenheimer Industries, Inc.) [hereinafter *Impact Hearings*].

> or transfer the land.[238]

The validity of this proposition is open to serious question. A detailed study prepared by the General Accounting Office *before FIRPTA was enacted* found that "foreign purchasers did not consistently pay more than U.S. buyers for similar land."[239] In other words, foreign investors typically bought at market prices and did not exploit their pre-FIRPTA tax advantage by making higher bids. Even if this had not been the case, those higher prices would presumably have gone to the landowners who sold their properties to the foreign investors—usually, American citizens. But the fact remains that the tax advantage eliminated by FIRPTA was not a significant factor affecting United States real estate prices.

Alternatively, a tax-exempt foreign seller might arguably sell his property for *less* money than a domestic seller would require to achieve the same return on his investment. Assume, for example, that land purchased last year for $100 is now worth $150. A domestic investor would sell it for $150, pay a $10 tax—(20%)[240] —on his $50 capital gain ($150 less cost of $100) and achieve a 40% return on investment (after-tax profit of $40 on a $100 investment). A tax-exempt foreign seller, however, could sell the property for $140 and realize the same result. But if the property was worth $150, the foreign investor would probably sell it for that price also, without factoring in his tax exemption.[241] Moreover, even if the foreign investor did sell his parcel at the lower price, the beneficiary of this action is the purchaser, most likely an American, who obtains the parcel at a lower price. In other words, the pre-FIRPTA tax advantage often redounded to the *benefit* of domestic landowners, if it had any effect on prices at all. Inasmuch as that effect was largely illusory, however, the case for FIRPTA in terms of its reducing United States land prices (or discouraging foreign investment, for that matter) seems fairly weak.

C. FOREIGN LAND OWNERSHIP GENERALLY

Even if FIRPTA might have an effect on foreign investment in United States real estate, there are significant policy questions about the wisdom of such an enactment. Put quite simply, why should foreign investment in real estate be discouraged at all, through tax policy or otherwise? Proponents of foreign land ownership restrictions claim that such investments tend to raise the price of real estate generally,[242] jeopardize its effective utilization and preservation,[243] and threaten United States food supplies.[244] These contentions, however, are highly exaggerated, if not entirely specious.

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[238] 124 CONG. REC. 34,606 (1978) (statement of Senator Church); *see also id.* at 34,604-05 (remarks of Senator Wallop to same effect); Drinkhall & Guyon, *Real-Estate Purchases by Foreigners Climb, Stirring Wide Debate*, Wall St. J., Sept. 26, 1979, at 1, col. 1 (tax advantage thought to give foreigners some price advantage).

[239] GAO REPORT, *supra* note 4, at 67. *See generally* Jansma, Goode & Small, *Economic Effects of Foreign Farmland Investments on Farms and Rural Communities*, in 3 U.S. DEP'T OF AGRICULTURE, *supra* note 234, at 1, 56-57 (no conclusive evidence that foreigners pay more for land).

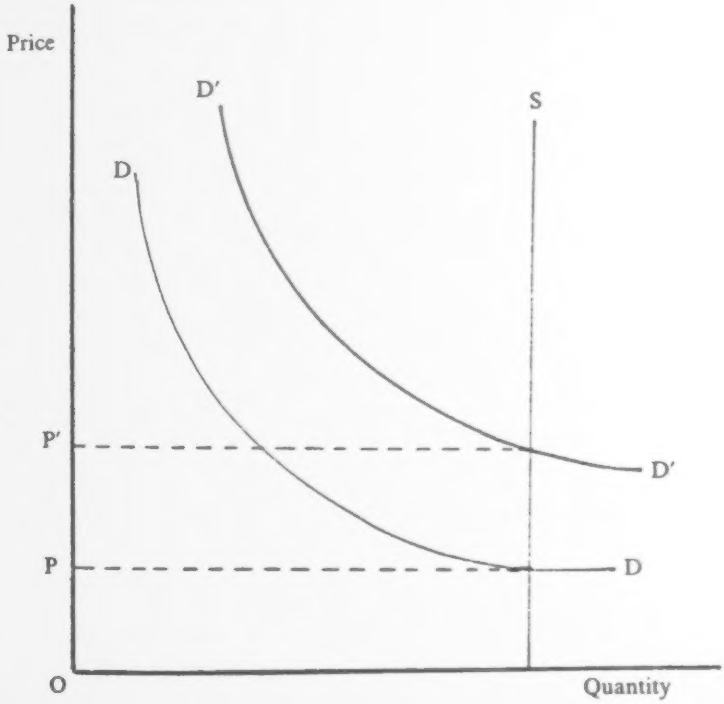
[240] *See* I.R.C. §§ 1, 1202(a) (Supp. V 1981) (after 60% exclusion, only 40% of gain is subject to tax; at highest tax rate of 50%, maximum capital gain tax rate becomes 20%).

[241] On the effect of a seller's tax-exempt status on his prices generally, see Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1465-66 & nn.211-13 (1980).

[242] *See Impact Hearings, supra* note 237, at 21 (statement of Representative Krebs); *Taxation of Foreign Investment in the United States: Hearing on S.192 and S.208 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance*, 96th Cong., 1st Sess. 26 (1979) (statement of Senator Wallop); E. FRY, *supra* note 218, at 5.

1. Effect on Land Prices

As a matter of economic theory, if demand increases for a commodity whose supply is fixed, such as land, its price must rise.[245] This relationship is often set forth graphically as follows:



Where S represents the fixed supply, D' represents the increased demand over D, and P' represents the higher price (over P) that results. Thus, if foreign capital increases the demand for United States land, the price of that land can be expected to rise. This higher price, of course, would result from *any* increase in demand, not just an increase from foreign investment. If American investors increased their investments in real estate and decreased their investments in stocks and bonds, for example, the same effect on land prices would result. Foreign capital, in other words, is not terribly unique in its ability to raise real estate prices.

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[243] *See* SENATE STUDY, *supra* note 232, at III; *Impact Hearings*, *supra* note 237, at 21 (statement of Representative Krebs).

[244] *See* E. FRY, *supra* note 218, at 115.

[245] *See* P. SAMUELSON, ECONOMICS 54-59 (11th ed. 1980); R. GILL, ECONOMICS 40-42 (3d ed. 1978). *See generally* J. HENDERSON & R. QUANDT, MICROECONOMIC THEORY 96-110 (3d ed. 1980).

In any case, there are at least three reasons why the influx of foreign capital into United States real estate should be of little concern. First, rising real estate prices are not necessarily bad, because most of the increased value of those properties accrues to domestic landholders.[246] Citizens who choose to sell their holdings benefit most directly, but other landowners also benefit from the appreciation in value of their investments.

Second, land prices are determined by many factors, not just by aggregate demand. These other factors include, among others, the availability of financing, the level of interest rates, world food supplies, location, accessibility of public services (sewage, water, and so forth), and the relative attractiveness of alternative investments.[247] In fact, the price of United States land, particularly farmland, has actually declined in recent months, in some cases substantially,[248] despite the influx of significant foreign investment.[249] Hence, the assertion that foreign investment alone causes the price of real estate to rise is overly simplistic.

Finally, foreign holdings are still much too small in the aggregate to have any discernible impact on real estate prices. The 1982 report of the Department of Agriculture shows that foreign investors own less than one percent of all United States farmland,[250] and the results for urban real estate are no doubt comparable. To be sure, a precise census of foreign landholdings is probably impossible,[251] but it seems unlikely that the uncounted holdings greatly exceed the counted holdings. Thus, foreign investment is a minor component of aggregate demand for United States real estate, and its effect on land prices, therefore, must be insignificant.

2. Property Utilization and Preservation

The notion that foreign owners are less attentive than Americans to the needs and development of their properties is similarly devoid of support. In the case of urban properties, on-site managers—who usually are Americans—operate the foreign owners' apartment buildings, office towers, and shopping centers seemingly without regard to the nationality of the property's owners. Typically, foreign investors acquire established projects, and tenants and other users are often unaware that there has been any transfer of ownership at all. There may be exceptions, of course, but for the most part, foreign investors are well-capitalized and make every effort to maintain or improve the status of their United States properties.

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[246] *See* U.S. DEP'T OF AGRICULTURE, FOREIGN OWNERSHIP OF U.S. AGRICULTURAL LAND 8 (1982) (Americans own all but one percent of U.S. farmland) [hereinafter 1982 CENSUS].

[247] *See generally* U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE MARKET DEVELOPMENTS 4-11 (1979) (discussing factors affecting price of farmland); Luttrell, *The "Danger" from Foreign Ownership of U.S. Farmland*, 61 FED. RES. BANK ST. LOUIS 2, 7 (1979) (same); Comment, *Economic and Political Impacts of Taxation of Foreign Investment in United States Agricultural Land*, 15 TEX. INT'L L.J. 287, 291-94 (1980) (same). Many of these factors also affect the price of urban real estate.

[248] *See* Hill, *Home Prices' Plunge, Steeper Than It Seems, Could Slow Recovery*, Wall St. J., June 17, 1982, at 1, col. 6.

[249] *See* 1982 CENSUS, *supra* note 246, at 13; *see also* GAO REPORT, *supra* note 4, at 43 (nonlocal United States and foreign investors acquired 24% of all farmland that was sold).

[250] 1982 CENSUS, *supra* note 246, at 8.

[251] Kaplan, Book Review, 129 U. PA. L. REV. 486, 488-89 (1980); *see also* 1982 CENSUS, *supra* note 246, at 59-62.

Foreign-owned agricultural properties present much the same picture, with local managers once again operating these properties in largely conventional ways. The properties do not lie fallow and in fact are often *better* maintained under the foreign investor's ownership.[252] Particularly because most foreign owners are interested in their properties' long-term prospects, the risk of underutilization or improper maintenance of foreign-owned United States real estate seems trivial at most.

3. United States Food Supplies

Emotionalism reaches its peak on the question of foreign ownership of United States food-producing land, even though FIRPTA applies to all forms of real estate, including downtown office buildings.[253] The contention here is that foreign owners will seize the fruits of our national heritage to satisfy foreign demand and alleviate famine in faraway lands. In point of fact, there is absolutely no evidence that foreign owners of United States farmland have ever contemplated such plans, let alone that they could implement them. To the contrary, these owners have shown no inclination to market their products any differently than their American counterparts, who themselves have little hesitancy about dealing with foreign buyers. In any case, foreign investors own such a small portion of United States farmland,[254] and are so unlikely to acquire a significantly larger portion any time soon,[255] that the effect of any diversion of farm produce would probably be indiscernible. Particularly when one considers the farm acreage that has been taken out of production to maintain United States farm prices, the prospect of diminishing food supplies is patently absurd.

In short, there is no rational reason to discourage foreign investment in United States real estate. Quite to the contrary, real estate is probably the safest form of foreign investment in terms of national security interests.[256] Stocks and bonds can be dumped on the market at a moment's notice, precipitating financial chaos and substantial price declines.[257] Similarly, bank deposits can be removed instantaneously, throwing even major depository institutions into insolvency,[258] as certain Arab investors have in fact threatened.[259]

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[252] *See* SENATE STUDY, *supra* note 232, at 53; GAO REPORT, *supra* note 4, at 80; *see also* 1982 CENSUS, *supra* note 246, at 26, 30; U.S. DEP'T OF AGRICULTURE, FOREIGN OWNERSHIP OF U.S. AGRICULTURAL LAND 26-27 (1980); Luttrell, *supra* note 247, at 8.

[253] *See* I.R.C. § 897(a), (c)(1)(A)(i) (Supp. V 1981).

[254] *See* 1982 CENSUS, *supra* note 246, at 8 (foreign owners control less than one percent of U.S. farmland).

[255] *See* U.S. DEP'T OF AGRICULTURE, ANALYSIS OF FOREIGN INVESTMENT IN U.S. FARMLAND (1978), *reprinted in* SENATE STUDY, *supra* note 232, at 76 (at current investment levels, foreign investors will need 19 years to acquire another 1% percent of United States farmland).

[256] *See generally* Gaffney, *Social and Economic Impacts of Foreign Investment in United States Land*, 17 NAT. RESOURCES J. 377 (1977); Luttrell, *supra* note 247, at 8 (suggesting expropriation if necessary as last resort).

[257] *See Foreign Investment in U.S. Understated, Private Report Says*, Wall St. J., June 23, 1981, at 18, col. 4 ("oil-exporting countries, acting as a block, could cause major disruption in the U.S. equity markets").

[258] *See* Davis, *The Petrodollar Trial*, MOTHER JONES, Nov. 1980, at 20, 27.

[259] *See* E. FRY, *supra* note 218, at 142 (describing an Arab threat to withdraw funds from Canadian banks should Canada move its Israeli embassy from Tel Aviv to Jerusalem).

But what can happen with land? By definition, it is fixed and immobile. Can a foreign investor remove his office building or repatriate his topsoil overnight? Would the Iranian Assets Freeze[260] have been necessary if those assets had been United States real estate holdings? Land, quite simply, is the most secure means of "recycling" foreign-held dollars, and any paranoia about foreign investments—whether justified or not—should argue for the encouragement, rather than the discouragement, of United States land acquisitions. To the extent, therefore, that FIRPTA even implies a contrary message, it is misdirected and wrong-headed.

VII. CONCLUSION

The Foreign Investment in Real Property Tax Act (FIRPTA) of 1980, as amended in 1981, is an unmitigated disaster. The "loophole" it closes was consciously created as a practical necessity and was restricted to a relatively limited class of foreign investors. To abolish this loophole, FIRPTA imposes a complex statutory regime that, despite an intrusive system of reporting requirements, is of questionable enforceability. Furthermore, for the new statute to have even facial effectiveness, it was necessary for Congress to override conflicting tax treaty provisions, a move that is without modern precedent or foreseeable long-term consequences.

Even more problematic are FIRPTA's confused policy objectives. The supposedly horrific inequity of foreign versus domestic taxation actually remains unchanged, except for the special case of real estate dispositions. The clear intention of this statute, therefore, is not to eradicate inequities, but rather to discourage foreign investment in United States real estate, a goal for which FIRPTA is singularly unsuited. In any case, the goal itself manifests a disturbing xenophobia that lacks any economic rationale or common sense foundation. The new statute, quite clearly, is flawed beyond amendatory repair and should be repealed in its entirety at the earliest opportunity.

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[260] Exec. Order No. 12,170, 3 C.F.R. 457 (1980), 50 U.S.C. § 1701 note (Supp. IV 1980); *see also* Dames & Moore v. Regan, 453 U.S. 654, 662-68 (1981) (describing freeze of Iranian assets).

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